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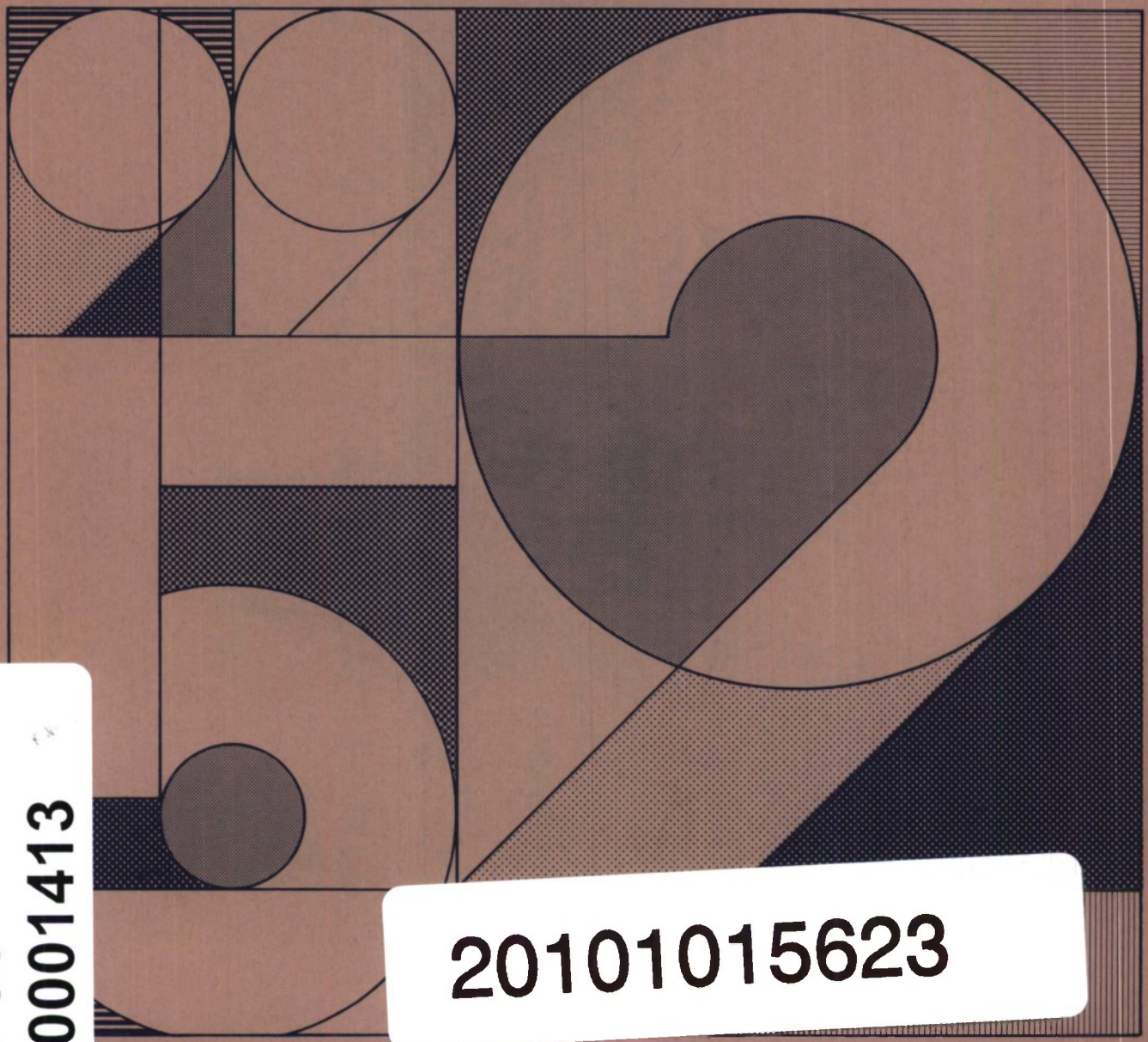
ONGRESS OF THE UNITED STATES
ONGRESSIONAL BUDGET OFFICE

JANUARY 1987

Reducing the Deficit: Spending and Revenue Options

A Report to the Senate and House Committees on the Budget — Part II

As Required by Public Law 93-344



1987 ANNUAL REPORT

REDUCING THE DEFICIT:

SPENDING AND REVENUE OPTIONS

The Congress of the United States
Congressional Budget Office

[redacted]

NOTES

Unless otherwise indicated, all years referred to in this report are fiscal years.

Dashes in tables in this report indicate amounts less than $2.5 million.

Details in the text and tables of this report may not add to totals because of rounding.

The Balanced Budget and Emergency Deficit Control Act of 1985 is also referred to in this volume more briefly as the Balanced Budget Act.

PREFACE

The Congressional Budget Office (CBO) is required by section 202(f) of the Congressional Budget Act of 1974 to submit an annual report on budgetary options to the Senate and House Committees on the Budget. This year, the report is in two parts, with this report constituting Part II. Part I is entitled *The Economic and Budget Outlook: Fiscal Years 1988-1992.*

This report provides background information for each major spending area of the budget and for revenues, and analyzes various specific options that would reduce the deficit. The inclusion of an option in the report, or the omission of one, does not imply a recommendation by CBO.

All divisions of the Congressional Budget Office contributed to this report, which was prepared under the supervision of Robert W. Hartman. Alfred B. Fitt was responsible for Section I. John D. Mayer, Maureen McLaughlin, Roger Hitchner, Jenifer Wishart, Earl A. Armbrust, and Rosemarie Nielsen were responsible for coordinating the specific deficit reduction options in Section II of this volume. Budget authority and outlay estimates were coordinated by Charles E. Seagrave, Robert A. Sunshine, Michael A. Miller, and William P. Myers. Revenue and outlay projections were prepared under the supervision of Rosemary D. Marcuss and Paul N. Van de Water, respectively. The Joint Committee on Taxation provided estimates of most of the revenue options.

Paul L. Houts supervised the editing and production of the report, assisted by Nancy H. Brooks. Major portions were edited by Patricia H. Johnston, Francis S. Pierce, and Sherry Snyder. Others who assisted in preparing the manuscript for publication were Mary V. Braxton, Jill Bury, Gwen Coleman, G. William Darr, Antoinette V. Foxx, Shirley G. Hornbuckle, Patricia A. Joy, Norma A. Leake, Angela Z. McCullough, Betty J. Miles, Ronald Moore, and Kathryn Quattrone. Additional assistance was provided by Shelbah Adams.

Rudolph G. Penner
Director

January 1987

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SECTION I

REDUCING THE DEFICIT: AN OVERVIEW

The Balanced Budget and Emergency Deficit Control Act of 1985 (the Balanced Budget Act) instructs the 100th Congress to adopt a budget plan for 1988 with a deficit no larger than $108 billion. But if the policies left in place by the 99th Congress are continued by its successor, the likely deficit for 1988 will be $169 billion, as shown in Table I-1 on the next page.

Unless the maximum deficit targets prescribed in the Balanced Budget Act are amended, the budget resolution for 1988, which is due to be adopted by April 15, 1987, must close a gap of $61 billion. 1/ That amount corresponds to a 5.7 percent cut in 1988 outlays or a 6.8 percent rise in revenues.

If all of the excess 1988 deficit is eliminated on the spending side of the budget, some programs must be hit much harder than the 5.7 percent mentioned above. This imbalance occurs because still other programs are constitutionally shielded from any reduction at all--interest on the debt, contract obligations, judgments against the United States, and so forth. Technical factors and political consensus insulate yet other programs as well. For example, the Balanced Budget Act protects so many programs--mainly entitlements--from contributing significantly to deficit reduction that CBO estimates the act's rules would force a 14 percent reduction in 1988 budget resources for national defense and a 20 percent cut in the unprotected nondefense programs. 2/

As for the alternative of reaching the 1988 deficit target entirely by raising taxes, a 6.8 percent rise would mean total federal government reve-

---

1. The Balanced Budget Act permits the target to be exceeded by $10 billion before spending reduction procedures are set in motion, but that leeway is not granted in preparing the budget resolution. It *must* aim for a deficit of no more than $108 billion.

2. CBO and the Office of Management and Budget (OMB) will make a joint estimate for 1988 in August 1987. It will take account of enacted legislation and other developments affecting the budget outlook and will average the estimates of the two agencies. The August report will almost certainly differ from CBO's current estimate of 1988 spending reductions called for by the Balanced Budget Act.

nues that year equal to 20.5 percent of projected Gross National Product (GNP), a higher percentage than any other year since World War II. Such a rise is the equivalent of a 16 percent personal income surtax.

THE CONTEXT FOR MAKING BUDGET DECISIONS

Table I-2 shows actual outlays by major category for 1985 and 1986, together with the CBO projection of those outlays for the following six years. (The major categories are described in the accompanying box.) The most important message to be found in the table is that federal spending, which had been rising as a proportion of GNP, is expected to decline if current policies are continued. This reversal occurs largely because defense appropriations, having had high real growth in recent years, are now assumed to stay constant in real terms, and because projected interest rates are substantially lower than those experienced earlier in the 1980s. To the extent that the 100th Congress reaches budget targets with less spending than that shown in the baseline, the federal share of GNP will be correspondingly less.

TABLE I-1. CBO BASELINE DEFICIT PROJECTIONS
(By fiscal year)

	Actual	Base	Projections				
	1986	1987	1988	1989	1990	1991	1992
Outlays	990	1,008	1,069	1,124	1,184	1,247	1,305
Revenues	-769	-834	-900	-962	-1,050	-1,138	-1,220
Deficit a/	221	174	169	162	134	109	85
Target Deficit b/	-172	-144	-108	-72	-36	-0	n.a.
Excess Deficit	49	30	61	90	98	109	n.a.

SOURCE: Congressional Budget Office.

NOTE: n.a. = not applicable.

a. For the economic assumptions used in deriving the projected deficits, see CBO, *The Economic and Budget Outlook: Fiscal Years 1988-1992* (January 1987).

b. The maximums as prescribed in the Balanced Budget Act.

The table also discloses the severity of long-range spending cuts that must be made if the Balanced Budget Act's 1991 zero deficit target is to be met with no changes in baseline revenues. Under those circumstances, outlay growth from 1987 to 1991 can be only $130 billion instead of the $239 billion growth that would follow from adhering to current policy. Unless laws are changed, entitlements alone--mainly Social Security and Medicare--are projected to grow by $136 billion from 1987 through 1991, implying negative growth in nominal dollars for defense, interest, and everything else.

On the other hand, if the 1991 zero deficit target is met solely by raising taxes, the probable required share of GNP for federal revenues would

TABLE I-2. BASELINE OUTLAY PROJECTIONS
(By fiscal year)

Major Category	Actual 1985	Actual 1986	Projections 1987	1988	1989	1990	1991	1992
			In Billions of Dollars					
National Defense	253	273	280	290	303	317	332	346
Entitlements and Other Mandatory Spending	440	456	481	512	544	578	617	660
Nondefense Discretionary Spending	172	171	166	185	193	204	213	220
Net Interest	129	136	135	141	147	152	155	154
Offsetting Receipts	-48	-47	-53	-59	-63	-66	-70	-75
Total	946	990	1,008	1,069	1,124	1,184	1,247	1,305
			As a Percent of GNP					
National Defense	6.4	6.6	6.4	6.2	6.0	5.9	5.7	5.6
Entitlements and Other Mandatory Spending	11.2	11.0	10.9	10.9	10.8	10.7	10.7	10.7
Nondefense Discretionary Spending	4.4	4.1	3.8	3.9	3.8	3.8	3.7	3.6
Net Interest	3.3	3.3	3.1	3.0	2.9	2.8	2.7	2.5
Offsetting Receipts	-1.2	-1.1	-1.2	-1.3	-1.2	-1.2	-1.2	-1.2
Total	24.0	23.8	22.9	22.8	22.3	21.9	21.5	21.1

SOURCE: Congressional Budget Office.

NOTE: Includes Social Security outlays, which are off-budget.

FEDERAL SPENDING CATEGORIES

National Defense. Outlays for military and civilian personnel, operating costs, weapons procurement, research and development, and military construction.

Entitlements and Other Mandatory Spending. Programs in which spending is governed by a law making all who meet their requirements eligible to receive payments. Subcategories are:

> **Health Care.** Includes outlays for Medicare and for the federal share of Medicaid expenditures.
>
> **Social Security and Other Retirement and Disability Programs.** Includes old-age, survivors, and disability benefits under Social Security, as well as other federally financed retirement and disability programs, including federal civil service and military retirement and disability programs, veterans' pensions and compensation, and Supplemental Security Income.
>
> **Other Entitlements and Mandatory Spending.** Entitlements and other mandatory spending not included above. Major examples are: non-means-tested or partially means-tested benefits such as Unemployment Insurance and child nutrition; means-tested benefits such as Food Stamps and Aid to Families with Dependent Children; certain state and local grants such as the Social Services Block Grant; and agricultural price supports.

Nondefense Discretionary Spending. All nondefense programs for which spending is determined by annual appropriations, or by loan or obligation limits imposed in appropriation acts. The basic governmental legislative, judicial, and tax-collecting functions are included. A large part of this category represents the salary and expense accounts that finance the ongoing operations of the civilian agencies of government. Most grants to state and local governments (other than for benefit payments) and nondefense research and development are also in this category.

Net Interest. Interest payments on the federal debt, less interest received by trust funds and other interest payments to the federal government.

Offsetting Receipts. Proprietary receipts from the public and the employer share of employee retirement. Other receipts (for example, foreign military sales, trust fund receipts, and payments to trust funds) appropriately netted against outlays are included in the relevant categories above.

exceed 21 percent, higher than the peak reached in World War II. The exact percentage needed would depend, of course, on when taxes were raised.

The figures in Table I-2 also suggest that current policy means the absence of any dramatic shifts over the next five years among the major categories, but the aggregates conceal a large program that has replaced interest on the national debt as the one whose federal costs are growing most rapidly: farm income stabilization. In the five years ending with 1982, annual outlays for that purpose averaged about $10.3 billion. In the next five years, the annual average grew to $22.9 billion, and CBO now projects the average for the 1988-1992 period will be $24.5 billion. For this reason, Section II includes a special discussion of the farm stabilization program.

Sale of Assets

Although the sale of assets by the government reduces the deficit under current accounting conventions, this report does not include any options that have the primary purpose of lowering the deficit with sale proceeds. The omission is not because such sales are always inappropriate; indeed, the sale of surplus federal property is a common and thoroughly appropriate activity. Moreover, the sale of newly created federal assets that are financial instruments--like loans to students or small business firms--would provide valuable market signals about their true value to the government and the real cost of the subsidy currently being conveyed to the borrower. (Sales of loans made in prior years have no particular use as a measuring rod since the subsidy has long since been granted.)

Most such sales do nothing, however, to ameliorate the long-term deficit. They produce some welcome cash in the sale year, but they do not make a contribution to narrowing a chronic gap between spending and revenue. The asset sale may be attractive in the short term, but only at the price of giving up future revenues that the asset would have generated for the government. In short, current deficit relief by this means may well lead to a still more vexing deficit problem later on.

Another point about asset sales is that they squeeze credit markets in almost the same fashion as borrowing by the government. The amount paid for the asset is no more available for private investment than is a like amount loaned to the Treasury. Thus, it is more appropriate to debate asset sales under such rubrics as privatization, efficiency, and management reform than in the context of long-term deficit options.

In many cases, the debate may lead to a conclusion in favor of a sale. But there are strong arguments against counting the proceeds toward reducing the deficit; instead, they might well be counted as a means of financing the deficit, just as the sale of Treasury bonds is counted. This treatment would eliminate the distortions created by the current accounting of sale proceeds. 3/

USES OF THIS VOLUME

This report lists 97 options that the Congress may wish to consider as it grapples with the deficit problem; 77 involve spending cuts and 20 would add to revenues. For each option, there is a short description of the arguments for and against its enactment, together with the estimated savings or revenue gains for each of the years 1988 through 1992. 4/

The Congressional Budget Office does not make policy recommendations except in the narrow area of budget process, so the appearance of an item among the listed options cannot be taken as a CBO endorsement of its enactment. Similarly, the absence of an item should not be construed as CBO opposition to its passage. The list is simply a nonexhaustive compilation of measures already in the public domain, so to speak. While consideration of any one of them is virtually certain to cause controversy, none is intended to be so extreme as to be implausible.

Almost all of the options in this report have been considered by past Congresses and, by definition, have failed to be enacted. But something has to give if the 100th Congress is to meet the Balanced Budget Act's targets, so the list includes items known to be unpopular, or previously voted down in both Houses.

Section II of this report is in six parts, each one with a brief subject introduction followed by the options relevant to the part: defense, entitlements, farm price supports, the federal civilian work force, nondefense discretionary programs, and revenues.

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3. For more discussion of this issue, see CBO, *An Analysis of the President's Budgetary Proposals for Fiscal Year 1988* (forthcoming).

4. The savings and gains are calculated against the CBO baseline, except for the defense options, where the reductions are from the program in the President's 1988 budget recommendations.

For a listing of individual options grouped by subject, see the Table of Contents. For a listing of options grouped by budget function, see the Appendix.

The reader should keep several cautions in mind. The separate options cannot be added to a grand total. A number of them are mutually exclusive, so that summing them would produce a meaningless figure. The savings effects of each are calculated separately, as if none of the other options were to become law, but in fact there would be interactions among the options if many of them were enacted. As a result, the consequences of enacting a package would be different from enacting each of its components in isolation.

The deficit reductions discussed in this volume represent only a first approximation of savings that might actually be realized. Variations on any particular option can, of course, be used to vary the savings it is likely to achieve. In some instances, a reduction in one program might result in program expansion elsewhere. Narrowing eligibility for VA hospital care, for example, would lead to some increase in Medicare outlays. In most cases, unless otherwise specified, such offsetting effects are not included in the estimates presented in this report.

Any enduring reduction in outlays or increase in revenues will ultimately result in a lower public debt, and therefore in lower net interest outlays than would otherwise be the case. Thus, a one-dollar cut in a spending program or a one-dollar tax increase lasting for the 1988-1992 period implies--at CBO's projected interest rate--an interest saving during 1993 of about 32 cents. While one could calculate such savings for any specific deficit reduction measure, the number would not be particularly useful since it would depend entirely on how many years of cumulative deficit reductions were assumed. The useful number is the net impact on interest outlays stemming from the whole budget enacted by the Congress. Hence, the estimates for specific options do not include induced interest savings.

In general, the estimated savings or revenue gains calculated for the deficit reduction options in this volume are derived from the economic assumptions underlying the CBO baseline. If different economic assumptions were used, or on the implementation of a budgetary plan that itself produced different economic results, then the savings and revenue gains from many of the options in this volume would have to be reestimated.

SECTION II

SPENDING AND REVENUE OPTIONS

NATIONAL DEFENSE

The national defense portion of the federal budget supports two major activities: developing and procuring equipment for the armed forces and paying personnel to operate and maintain this equipment. In 1987, about 54 percent of the budget authority in the national defense function will be spent for personnel and for operation and support of the forces. The remaining 46 percent, referred to as the "investment accounts," will fund the research and development, procurement, and military construction associated with armed forces equipment (see Figure 1). From another perspective, national defense spending is devoted to several military purposes (so-called "missions"), with general purpose forces (that is, all those except strategic nuclear forces) receiving the largest share. Although spending for strategic nuclear forces often generates substantial debate, it will account for only about 13 percent of the total defense budget in 1987, according to Administration estimates.

After experiencing six consecutive years (1980-1985) of substantial real--or inflation-adjusted--growth, budget authority for national defense showed a real decline in 1987 for the second straight year (see Figure 2). This decrease resulted in part from overall budgetary pressures to reduce the deficit. Still, by postwar standards, real budget authority for defense remains high. As a percent of gross national product, defense spending is up from its 1980 level but well below the historical peacetime trends (see Figure 3). Defense outlays grew from roughly 5.0 percent of GNP in 1979 to 6.6 percent in 1986. This latter measure of the defense budget is perhaps the most comprehensive way to assess the resources the United States devotes to its security.

The portion of the defense budget devoted to investment has stabilized, but at a high level that has implications for budget flexibility. In 1987, 46 percent of defense budget authority will be allocated to investment, compared with only 37 percent in 1980. 1/ This apportionment is significant because emphasis on investment can constrain attempts to reduce defense outlays quickly. The Congress appropriates budget authority,

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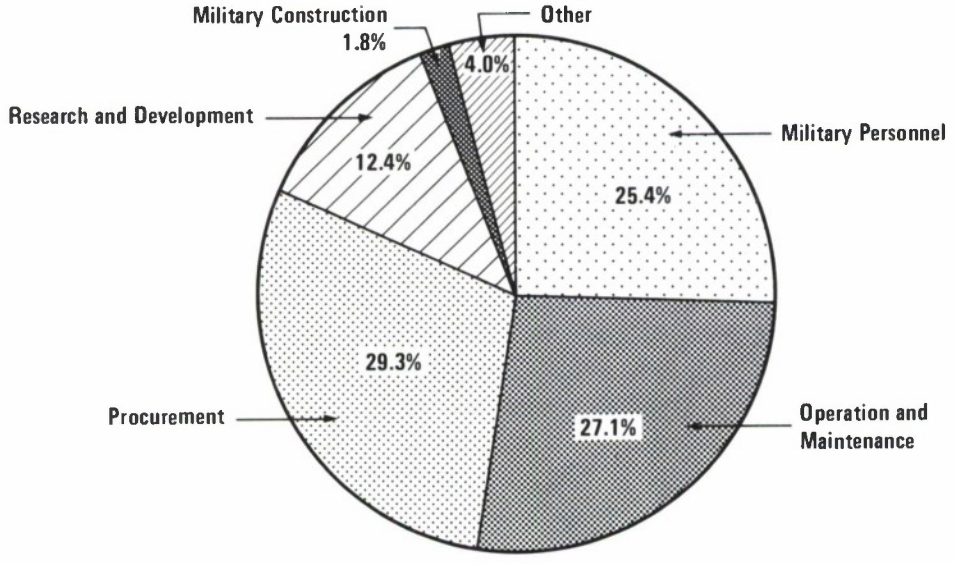
1. This shift in apportionment does not necessarily imply that the operating and support appropriations (that is, the operation and maintenance and military personnel accounts) are underfunded. In fact, since 1980 the operating accounts have increased in real terms by almost $25 billion, or nearly 20 percent.

which represents the right to enter into contracts for defense goods and services. Actual spending, or outlays, can take place over a number of years, depending on the nature of specific contracts. The lag of outlays behind Congressional authorizations is particularly long for weapons procurement. For example, for each dollar of budget authority provided each year in the procurement accounts, only 13 cents, on average, contributes to the outlays for that year. On the other hand, about 80 cents of each dollar authorized in the operation and maintenance accounts in a given year contributes to that year's outlays. It is outlays that affect the budget deficit, not budget authority. Therefore, in a budget plan with a high amount of investment budget authority in a certain year, the Congress could face two choices if it wished to realize near-term reductions in outlays and, thus, significant deficit reductions: either cut operating and support appropriations sharply or effect steeper cuts in overall defense budget authority.

THE ADMINISTRATION'S 1988 DEFENSE REQUEST AND ALTERNATIVES

In its budget for 1988, the Administration proposes to return to real increases in defense spending, although at a more moderate pace than those of the early 1980s (see Figure 2). The 1988 Department of Defense (DoD)

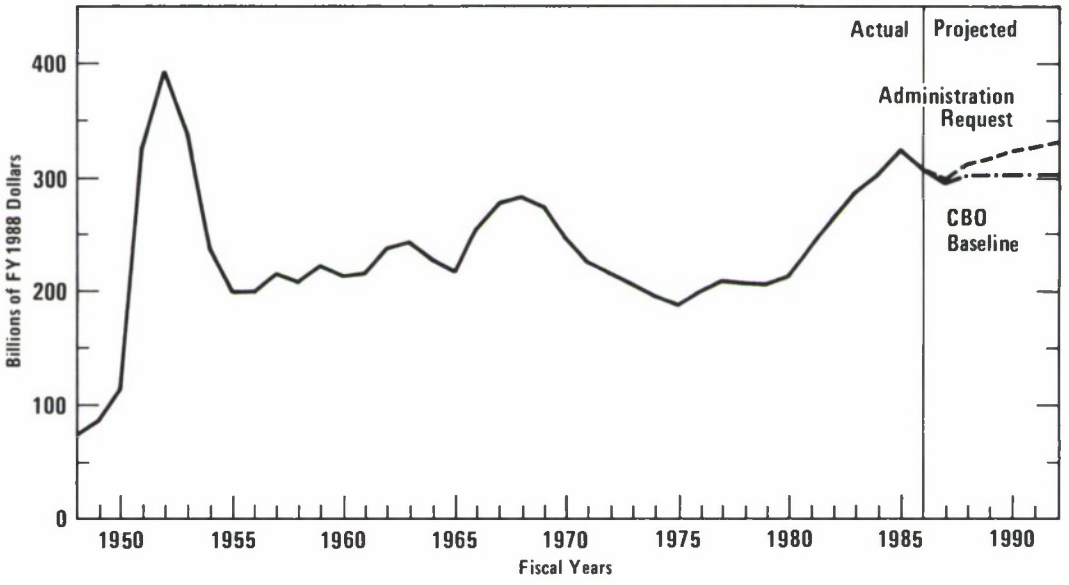
Figure 1.
Fiscal Year 1987 Defense Budget Authority by Appropriation Account



SOURCE: Congressional Budget Office.

Figure 2.

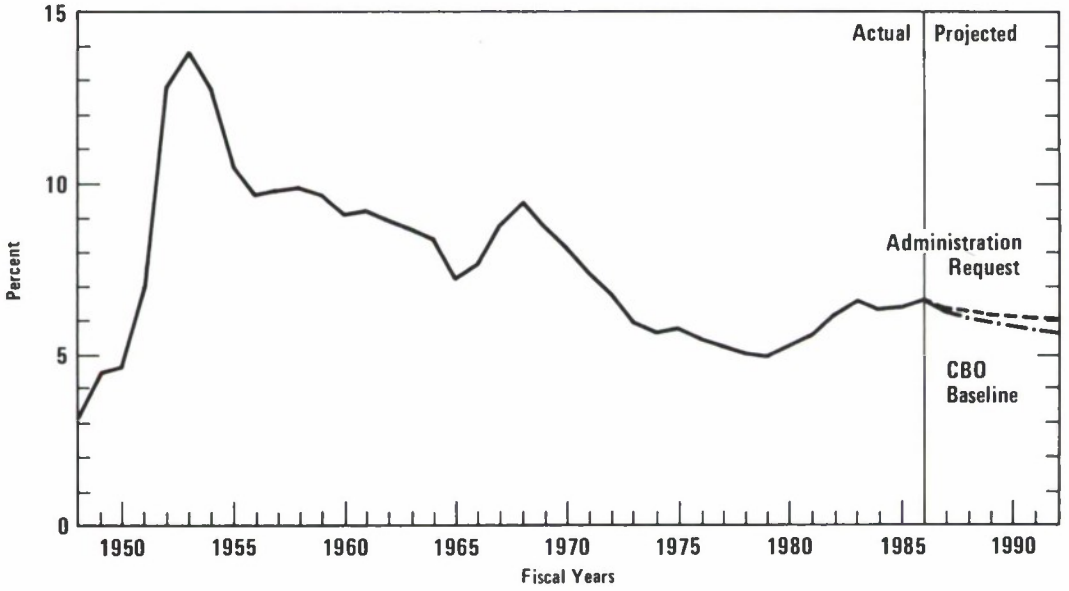
National Defense Budget Authority, Fiscal Years 1948-1992



SOURCE: Congressional Budget Office.

Figure 3.

National Defense Outlays as a Percent of GNP, Fiscal Years 1948-1992



SOURCE: Congressional Budget Office.

five-year plan requests $312.0 billion in national defense budget authority and $297.6 billion in outlays for 1988; by 1992 budget authority rises to $396.9 billion and outlays to $370.9 billion (see Table II-1). For budget authority, this request represents real growth of 3 percent over fiscal year 1987 and an average real growth of 2.3 percent a year from 1988 to 1992, under CBO economic assumptions. The Administration proposals exceed the CBO baseline--which assumes no real growth in defense budget authority--by $10 billion in budget authority in 1988 and by $115 billion over the 1988-1992 period. Outlays exceed the baseline by $8 billion in 1988 and by $72 billion over the five years.

Reducing the Deficit: The CBO Baseline and the Administration's Request

In considering deficit reductions, the Congress establishes a revenue and spending baseline from which to make adjustments. During debate over the budget resolution for 1987, the Congress often used the CBO baseline. That

TABLE II-1. ALTERNATIVE LEVELS OF DEFENSE SPENDING
(By fiscal year, in billions of dollars)

Levels	Actual 1986	Estimated 1987	Projected 1988	1989	1990	1991	1992
CBO Baseline a/							
Budget Authority	289.1	289.6	302.1	315.9	330.2	345.4	361.2
Outlays	273.4	279.5	289.9	303.0	316.6	331.8	346.4
Administration's Request b/							
Budget Authority	289.1	292.9	312.0	332.4	353.5	375.0	396.9
Outlays	273.4	282.2	297.6	312.2	330.0	349.5	370.9

a. The CBO baseline maintains real defense budget authority at the zero growth level throughout the five-year period from 1988 through 1992, using CBO economic assumptions. Outlays are computed using currently estimated spending patterns.

b. The Administration's request is from Budget of the U.S. Government, various years; and Office of Management and Budget, January 5, 1987.

baseline assumed no real growth in defense budget authority, as does this year's version.

Should the Congress again adopt the CBO baseline for use in debating the budget resolution, then a reduction of $10 billion of budget authority from the Administration's request would be needed just to reach the CBO baseline level. But deficit reduction might require that the Congress approve a budget resolution with defense funding below the CBO baseline. For example, if the Congress were to approve budget authority for defense in 1988 at a level of $10 billion below the CBO baseline level, this amount would correspond to a level of $20 billion below the Administration's request.

If the Congress were to make such cuts, it could do so in many ways. In the past, some savings were achieved through use of inflation dividends ($2.6 billion in 1987), some through specific program reductions, and some through general reductions left to DoD to administer. 2/ Indeed, much of this chapter assesses the effects of specific program reductions that could be grouped together with other approaches into packages of changes. To provide a sense of the overall effect of such packages, the next few paragraphs discuss in general terms two strategies that would reduce budget authority $10 billion below the CBO baseline level and $20 billion below the Administration's request. Strategy I follows 1987 Congressional priorities in making 1988 reductions and applies to each 1988 appropriation account the same percentage of the total defense reduction that it received in 1987. 3/ Strategy II would parallel the approach under the Balanced Budget Act (assuming only those exemptions that are already provided in law). The act applies an equal percentage reduction to each appropriation. Table II-2 displays the levels of defense budget authority that would remain under each strategy when starting the reductions from the Administration's budget request. This does not imply that CBO believes that the Administration's defense budget request should be reduced to these amounts or that the strategies presented are the only ways to effect reductions. The levels and strategies chosen here are only for illustration.

Generally, operating costs (defined as appropriations for personnel and operation and maintenance) fare better under Strategy I than under Stra-

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2. When the Administration submits its budget, prices in the budget are based on the Administration's estimate of inflation in the future. When inflation that has been budgeted exceeds actual inflation, the difference is referred to as the "inflation dividend."

3. Budget authority for military personnel would be reduced by an amount equal to 6 percent of the total defense reduction, operation and maintenance by 28 percent, procurement by 36 percent, research and development by 21 percent, and military construction by 6 percent.

tegy II. Although spending levels for operation and maintenance are the same under either strategy, the personnel accounts under Strategy II are nearly $4 billion lower than under Strategy I. Strategy I might require reductions only in the growth in personnel and benefits requested in the Administration's plan, while Strategy II probably would require actual reductions in the current level of forces. Large reductions in force levels could lead to fewer forces stationed abroad or fewer ships deployed at sea at any one time. The amount of any reductions would depend on the amount of savings that could be achieved in other areas, such as recruiting and moving costs.

Investment levels (procurement, research and development, military construction, and atomic energy defense activities) would be higher under

TABLE II-2. LEVELS OF DEFENSE BUDGET AUTHORITY UNDER ALTERNATIVE BUDGET PLANS AND STRATEGIES FOR $20 BILLION REDUCTIONS FROM ADMINISTRATION'S BUDGET REQUEST, FISCAL YEAR 1988, BY APPROPRIATION ACCOUNT (In billions of dollars of budget authority)

Appropriation Account	Administration's Request	CBO Baseline	Repeat Past Priorities (Strategy I)	Uniform Percentage Cuts (Strategy II)
Military Personnel a/	78.3	76.1	77.1	73.3
Operation and Maintenance	86.6	83.4	81.0	81.0
Procurement	84.0	88.7	76.9	78.6
Research and Development	43.7	37.4	39.6	40.9
Military Construction	6.6	5.2	5.4	6.2
Other b/	12.8	11.3	12.0	12.0
Total	312.0	302.1	292.0	292.0

SOURCE: Congressional Budget Office.

a. Includes the Administration's proposed military pay raise.
b. Includes atomic energy defense activities.

Strategy II than under Strategy I. Thus, modernization would continue at a faster pace under Strategy II but more slowly than under the Administration's plan. Both strategies would slow production and research and development of many programs, but Strategy I probably would result in the cancellation or delay of a greater number of procurement and research programs. Under these strategies, investment would consume from 44 percent to 46 percent of the total DoD budget.

SPECIFIC OPTIONS

This section presents 22 specific options to limit spending for national defense. The first 11 alternatives offer lower spending levels by reducing the rate of growth in procurement programs for major systems, such as the MX missile, F-15 aircraft, the Trident submarine, and the C-17 cargo aircraft. Savings would be achieved either by canceling systems, as in DEF-01 and DEF-02, or by slowing the rate of procurement, as in DEF-05.

Options DEF-12 through DEF-15 consider limits on spending in other military investment accounts. Over the next five years, the Administration plans to spend large amounts in areas such as research and development and military construction. Options discussed here would achieve savings greater than those shown for these purposes in either of the strategies above by sharply reducing the rate of growth in these accounts.

Limits on growth in the military forces and on further improvements in readiness are discussed in DEF-16 through DEF-19. Although limiting growth in military forces would provide only small savings in the first year, these options would produce substantial savings once the options were fully implemented. Savings in the operation and maintenance option (DEF-17) are less than savings for this purpose in either of the strategies discussed above.

Finally, DEF-20 and DEF-21 offer savings by limiting the growth in pay and benefits for military personnel. These include alternatives to slow pay increases for active-duty personnel and to increase cost sharing for medical care for military dependents and retirees.

The estimates of savings for all options were made relative to the Administration's proposed budget, using CBO current economic assumptions. The Administration's budget contains the detail necessary to estimate savings for specific program options. When possible, savings relative to both the Administration's request and the CBO baseline are provided. In most cases, savings are rounded to the nearest 100 million dollars, and are given both in budget authority and outlays.

DEF-01 CANCEL PROCUREMENT OF THE F-15

Savings from Admin. Request	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Budget Authority	1,790	1,800	1,930	1,810	1,670	9,000
Outlays	170	810	1,350	1,590	1,700	5,620

The F-15 is the Air Force's premier fighter, capable of operating during day or night and in inclement weather. Its long-range radar and medium-range missile enable the F-15 to attack enemy aircraft before those aircraft can detect and attack the F-15. The Administration plans to purchase 210 of these aircraft over the next five years (42 per year), bringing to about 1,020 the total number of F-15s in the Air Force inventory. For the last three years, however, the Congress has authorized fewer F-15 aircraft than the Administration has requested. Because of the plane's expense, moreover, the Air Force developed the less capable, but cheaper, F-16 to fulfill its total force requirements. The Air Force will have purchased about 1,500 F-16s by the end of 1987 and plans to acquire an additional 870 aircraft from 1988 through 1992.

This option would cancel all further procurement of the F-15. Cancellation would save nearly $1.8 billion in budget authority in 1988 and $9.0 billion over the next five years. During this period, the Air Force will continue to develop the Advanced Tactical Fighter (ATF) at a cost of about $4.8 billion. According to design specifications, the ATF, intended to begin replacing the F-15 in the mid-1990s, should be superior to the F-15. Thus, if the ATF can meet all of its design objectives and enter the force as currently planned, it could provide the United States with a significant increase in tactical aircraft capability. Canceling the F-15 program would provide a greater degree of certainty that the ATF program would be funded as planned if the overall budget for Air Force tactical fighters were further constrained.

The Air Force can meet its goal of 37 tactical fighter wings without additional F-15 purchases and without changing current retirement plans for the F-4s. The Air Force inventory currently contains about 1,000 F-4 fighter aircraft. Cancellation of the F-15 would reduce overall U.S. capacity to produce aircraft, a potential problem in a lengthy war. Furthermore,

the Air Force would acquire only 50 F-15Es--an improved version of the F-15 that the Air Force is now buying for its ground attack mission. This number might be too low to allow military planners sufficient flexibility for employing the aircraft in the broad range of ground attack missions for which it was developed.

DEF-02 CANCEL THE C-17 PROGRAM

Savings from Admin. Request	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Budget Authority	1,940	2,080	2,710	3,020	3,870	13,620
Outlays	690	1,270	1,500	1,850	2,330	7,640

The C-17 is the newest military transport aircraft. It is a four-engine, long-range plane that can carry a maximum payload of 86 tons and operate efficiently on smaller airfields. Along with other airlift aircraft, including the C-5 and the C-141, the C-17 would be used to transport high-priority military equipment and supplies quickly in the event of war.

The Administration requested $217.3 million in 1987 to prepare for procurement of the C-17. The Administration eventually plans to buy 211 C-17s at a cost of $34.5 billion. While the Congress ultimately approved most of the requested funds for 1987, it imposed considerable restrictions on their use, indicating some concerns about the program's justification. Specifically, the 1987 National Defense Authorization Act included a provision preventing the Air Force from obligating more than $64 million in procurement funds before April 15, 1987, by which time the Comptroller General is to report on the cost-effectiveness of the C-17 program and alternatives.

The Administration has requested about $724 million in 1988 to procure the first two aircraft, as well as $1.2 billion for continued development activities. This option would deny any further funds for the C-17. If no alternative aircraft were purchased, cancellation of the program would save $1.9 billion in budget authority in 1988 and $13.6 billion over the next five years.

Although canceling the C-17 would save considerable funds, this option has disadvantages. No currently produced aircraft combines the payload and small-field characteristics of the C-17. These features, coupled with improvements in cargo-handling equipment and performance, would facilitate deploying U.S. forces in difficult to reach areas with limited road networks, such as the Middle East or Central America. Moreover, U.S. strategic (intertheater) airlift capacity, even including the 50 C-5Bs now being procured, could not deliver all the materiel theater commanders say

should be airlifted in the event of a major conflict with the Soviet Union. Moreover, the current fleet of C-141B aircraft, which comprises most of the U.S. strategic airlift assets, is over 20 years old and could need replacement starting in the 1990s. Thus, necessary expenditures might only be deferred, not eliminated, by this option.

On the other hand, recent improvements to the airlift force have increased airlift capability 48 percent since 1981--to a level never before attained by the United States or any other country. As a result, U.S. airlift forces are adequate to cope with most contingencies short of an all-out global war. Thus, the Congress might decide to maintain the size of airlift forces at current levels, accepting the additional risk this implies, and target additional funds toward improving other elements of mobility, such as sealift or prepositioning of equipment and supplies abroad. Although it takes longer, shipping cargo by sea is far less costly than doing so by air.

DEF-03 CANCEL THE ANTISATELLITE MISSILE

Savings from Admin. Request	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Budget Authority a/	420	750	500	500	400	2,570
Outlays	220	430	440	440	390	1,920

a. Savings do not include potential savings either from the termination of programs for modifying the F-15 to carry the Miniature Homing Vehicle or from reductions in military base construction and O&M.

The U.S. antisatellite (ASAT) missile currently under development is being designed to destroy an orbiting enemy satellite by ascending directly into its path. The missile would be launched into space from an F-15 fighter aircraft. Problems with missile guidance and other technical subsystems have caused development delays that have led to increased total program cost. This greater cost, at least in part, has forced the Air Force to reduce the number of ASAT missiles in their procurement plan from more than 100 to 35 and to restrict the deployment of the ASAT equipped F-15 planes from two coasts to one.

Some members of the Congress also contend that U.S. development of a direct-ascent ASAT missile would cause the Soviet Union to develop a similar system, endangering U.S. satellites. The Soviet Union currently has an orbiting ASAT weapon, but it appears to be unreliable and has not been tested regularly in several years. Also, although the Soviet ASAT might be effective against low-altitude U.S. military satellites used for navigation, meteorological surveillance, and other purposes, it cannot reach critical U.S. early warning and communications satellites in high-altitude orbits. To help prevent an arms race between the United States and USSR in direct-ascent ASAT weapons, the Congress has barred the testing of the U.S. ASAT weapon against targets in space during fiscal years 1986 and 1987. The Administration, however, proposes to resume testing in 1988.

This alternative would cancel the current ASAT program and rely instead on evolving technologies that are part of the Strategic Defense Initiative (SDI) research. Savings in fiscal year 1988 would be $420 million in budget authority while savings over the next five years would total $2.6 billion. Some contend this option would not affect U.S. security because the

direct-ascent technology is rapidly becoming obsolete. Ground-based lasers or other directed-energy weapons now under study might prove to be more effective in "blinding" or destroying satellites. The Air Force, however, does not plan to decide until 1990 or 1991 whether to shift solely to a more advanced system developed under the Strategic Defense Initiative, or to continue to rely on direct-ascent weapons, or to pursue both technologies.

DEF-04 CANCEL TRIDENT REFIT PROGRAM

Savings from Admin. Request	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Budget Authority	60	200	130	310	280	980
Outlays	10	50	110	190	250	610

The U.S. Navy is currently developing and buying a new submarine-launched ballistic missile (SLBM), the Trident II, for deployment in Trident submarines. This new missile will be deployed as original equipment in the ninth and subsequent Trident submarines. The Navy plans to refit the first eight Trident submarines, currently armed with Trident I SLBMs, to carry the Trident II. This option would cancel the plan to deploy the Trident II on these eight submarines.

The Navy's rationale for the refitting program is based on the better accuracy and larger payload of the Trident II. Whereas the Trident I has moderate accuracy and carries eight Mark IV warheads, the Trident II will be roughly twice as accurate and will carry either about twelve Mark IV warheads or about eight more powerful Mark V warheads. The improved accuracy of the Trident II missile and the alternative of employing larger warheads would greatly enhance U.S. capability to destroy enemy targets, such as Soviet silos for intercontinental ballistic missiles (ICBM) and command and control centers, both of which are hardened to withstand nuclear blasts.

But the plan to refit the first eight submarines is expensive. Canceling the refits would save $60 million in budget authority in 1988 and nearly $1 billion over the next five years. This alternative would also reduce the procurement of the Trident II by about 180 missiles, saving about $6 billion, although these savings are not likely to be realized until the mid-to-late 1990s at the end of the Trident II procurement.

This option would preserve about 1,500 warheads capable of destroying softer targets instead of deploying about 1,900 new warheads with greater capability against hardened targets. Assuming that the United States deployed a fleet of 20 Trident submarines as currently planned, this change would not significantly affect the ability of the entire U.S. ballistic missile

force--including both land-based and submarine-based missiles--to destroy either small or large sets (500 to 2,000) of hardened enemy targets. This change, however, would decrease by about 10 percent the portion of a large set of hardened targets that could be destroyed by U.S. SLBMs alone. The SLBMs might have to attack these targets alone if U.S. land-based missiles were destroyed by a Soviet attack.

DEF-05 SLOW TRIDENT SSBN CONSTRUCTION

Savings from Admin. Request	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Budget Authority	1,330	150	10	1,310	150	2,950
Outlays	70	200	300	320	450	1,340

The Trident submarine is the Navy's most advanced platform for submarine-launched ballistic missiles (SLBMs), the sea-based leg of the U.S. strategic nuclear triad. The first eight Trident submarines now carry Trident I SLBMs (see DEF-04). Subsequent Trident submarines will carry the new Trident II missile, which is scheduled for deployment on the ninth Trident submarine in 1990.

As of 1987, the Congress has fully funded the construction of 14 Trident submarines and authorized advanced procurement for the sixteenth ship. According to the fiscal year 1988 Five-Year Defense Plan, the Administration plans in 1988 to fund fully the fifteenth ship and advanced procurement for the seventeenth ship. An additional submarine would be funded in each subsequent year of the current five-year plan.

The Congress could consider funding new Trident submarines at an average rate of one every 1.5 years as opposed to one every year as the Administration proposes. Indeed, in order to meet budgetary objectives, the House Armed Services Committee recommended in its report on the 1987 National Defense Authorization Act that the Trident submarine not be funded in 1987. This recommendation was reversed, however, in conference.

This alternative would not fund a Trident submarine in 1988 and would fund three rather than four submarines in the 1989-1992 period. This would save $1.3 billion in budget authority in 1988 and nearly $3.0 billion during the next five years. These savings would be permanent, however, only if the United States were to deploy fewer than the 20 Trident submarines the Navy currently envisions. Otherwise, the cost of acquiring the full 20 submarines would simply be deferred.

This option would certainly delay U.S. missile deployments, but, because of the long time period required to construct Trident submarines, the

delay would not affect deployments until 1994. By then, the United States would have deployed 24 fewer Trident II missiles than currently planned (192 rather than 216), and by 1997 this shortfall would grow to 48 missiles (360 rather than 408). A reduced number of Trident II missiles might be offset in part by extending the life of older Poseidon submarines.

DEF-06 RESTRUCTURE THE ARMY'S FORWARD AREA AIR DEFENSE PROGRAM

Savings from Admin. Request	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Budget Authority	300	490	510	310	220	1,830
Outlays	100	240	290	300	300	1,230

Following the cancellation of the Sergeant York Division Air Defense Gun (DIVAD) in August 1985, the Army initiated a program to improve its ability to defend troops positioned well forward in the battle area against enemy aircraft, particularly helicopters. This Forward Area Air Defense (FAAD) program contains five elements designed to: (1) improve communications among air defense weapons and sensors; (2) purchase a new weapon to perform the mission of the canceled DIVAD; (3) develop and procure a system to provide air defense for the rear of the battle area; (4) develop and procure a system to attack enemy helicopters hiding behind hills, trees, or buildings (a non-line-of-sight system); and (5) improve the air defense capability of the Army's existing helicopters, tanks, and fighting vehicles. The Army estimates that the total cost of this five-part program could be as much as $11 billion, about $5 billion of which would be required during fiscal years 1988 through 1992.

This alternative considers a restructured FAAD program, with the emphasis shifted from sophisticated and expensive "dedicated" (that is, devoted to a single purpose) air defense weapons to programs designed to upgrade Army tanks, fighting vehicles, and helicopters with a capacity to provide protection from enemy aircraft. Since the principal threat to the Army's forward area comes from helicopters, the program would emphasize providing all Army weapons with some ability to destroy enemy helicopters. For example, each fighting vehicle would be equipped with missiles that could be used against either tanks or helicopters, Army helicopters would be equipped with missiles capable of destroying enemy helicopters, and Army tanks would be provided ammunition with enhanced capability against hovering helicopters. Because each Army vehicle would be capable of defending troops against enemy helicopters, dedicated air defense weapons should be needed primarily to counter fixed-wing aircraft. The Stinger missile sys-

tem, currently in use by the Army, is designed to oppose fighter-bomber aircraft. A vehicle mounted version of Stinger, which is being developed as part of the FAAD program, could replace the older Chaparral system currently in the field and would provide needed capability. Savings under this alternative would be $300 million in budget authority in 1988 and $1.8 billion over the next five years. Savings reflect termination of the follow-on to the DIVAD program and cancellation of any further purchases of TOW missiles and Chapparal missiles and fire units, offset by the costs of equipping tanks, fighting vehicles, and helicopters as described above.

This alternative does not offer a substitute for a non-line-of-sight (NLOS) weapon capable of destroying enemy helicopters hiding behind obstacles such as buildings or ridges. But Soviet forces currently could not conceal their helicopters in this way and still fire at U.S. forces. Thus, although research could continue on a NLOS missile system to meet a potential threat, procurement plans now might be premature.

This alternative might also offer increased capability relative to the Army's plan in at least one area. The ability to destroy helicopters is, in part, a function of the total number of weapons that are capable of striking helicopters at a specific range. By this measure, this option could provide twice as much capability as the Army's plan.

On the other hand, this alternative does require that infantry and tank commanders assume greater responsibility for air defense, a situation that could adversely affect their ability to perform their mission of destroying tanks.

DEF-07 DEFER NEW PROGRAM STARTS UNTIL 1990

Savings from Admin. Request	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Budget Authority	8,350	12,220	5,980	7,750	4,320	38,620
Outlays	3,220	6,400	4,060	4,730	6,740	25,150

Although the Congress only appropriated 88.7 percent of the procurement funds requested by the Department of Defense for 1987, money was provided for initial production of several major new weapons. These include advance procurement funds for the C-17 strategic transport aircraft for the Air Force, the SSN-21 attack submarine for the Navy, and initial production funds for the 105MM light howitzer for the Army. The Congress funded these new programs in part through savings from reduced procurement rates for other weapons. The Air Force's request for 48 F-15 aircraft per year was reduced to 42, the Army's request for 870 Bradley Fighting Vehicles was lowered to 662, and the Navy's request for 120 F/A-18 aircraft was decreased to 84. In short, the Congress did not appropriate enough both to procure all of the weapons at the rates requested by DoD and to fund the new programs.

The DoD proposed budget for 1988 and 1989 contains funds for many new weapons. These include research and development funds of about $920.0 million in 1988 and $1.8 billion in 1989 for 13 new major weapons programs, including the Navy's Advanced Air-to-Air Missile system, the Air Force's mobile rail basing for the MX missile (see DEF-08), and a portion of the joint Air Force and Navy Air Defense Initiative. The DoD proposed budget also includes initial production funds of about $2.6 billion in 1988 and about $6.1 billion in 1989 for 16 major weapons programs, including the Army's Air Defense System (Heavy) (see DEF-06) and the Navy's T-45 jet trainer. In addition, there are other new research and development programs, including the Army's Airborne Adverse Weather Weapon System and the F-111 Self-Protection System for the Air Force which, although not designated as "major" programs, receive requests for comparable funding for 1988-1989. The DoD budget request also includes a number of major new "black" (classified) research and development programs.

The Congress could choose to defer development and procurement of many or all of these new programs until 1990 to preserve the development

and production rates of other weapons. Such an approach might avoid inefficiencies caused by reductions in planned development or rates of production of existing weapons and allow the DoD to complete development and procurement of some weapons more quickly. Savings as a result of deferring all new major program starts in research and development and procurement (including those discussed in DEF-02, DEF-06, and DEF-09) might be as much as $8.4 billion in budget authority in 1988 and $38.6 billion over the next five years. These savings assume that research costs for weapons that continue to be scheduled for procurement in 1988 are sustained at their 1987 level to ensure continuity of the programs.

Some loss in capability might be expected under this alternative, especially in areas such as communications or intelligence gathering for which DoD plans to begin procurement of many new systems soon. The loss of capability in some areas, however, might be offset somewhat by avoiding reduced acquisitions of weapons currently in production. In the long run, maintenance of efficient production rates should provide greater defense capability for the same expenditure.

DEF-08 REDUCE PURCHASES OF MX MISSILES

Savings from Admin. Request	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Budget Authority	940	1,580	970	1,260	1,150	5,900
Outlays	390	1,010	860	800	950	4,010

Over the next six years, the Administration plans to buy another 157 MX missiles which carry 10 warheads. Of these, 107 would be earmarked for a test program to establish and monitor the reliability of the missile. The other 50 missiles would be deployed in a mobile basing mode. They would be kept in railroad cars on military installations in peacetime and would be dispersed on existing rail lines during times of crisis. These 50 rail-based missiles would be additional to the 50 MX missiles currently approved for deployment in existing Minuteman missile silos. The total deployment of 100 MX missiles would be consistent with the recommendations of the 1983 Scowcroft Commission.

This option assumes that the Congress would allow the procurement of only 31 additional MX missiles, rather than the Administration's planned 157 missiles, for a total program of 50 deployed missiles and 47 test missiles. Under this option, production would be limited to no more than 12 missiles annually over the next three years. Savings would total $940 million in budget authority in 1988 and $5.9 billion over the five-year period. Alternatively, all 31 additional test missiles could be procured next year at an ultimate savings over the five years of $6.8 billion. Greater savings would be achieved because of more efficient production rates. Because this option would not permit deployment of the additional 50 rail-based missiles, it would eliminate the need to construct the mobile basing system and save about $1.8 billion for further research on this basing mode, including $0.9 billion in 1988.

With sufficient warning, rail-mobile basing would allow many of the 50 MX missiles to survive a Soviet attack and so would provide substantial additional capability to retaliate. The Administration argues that this additional capability is needed to deter nuclear war. On the other hand, rail-mobile missiles would require a number of hours of warning in order to disperse widely and so survive a Soviet attack; such warning might not be available in a crisis. Rail-mobile missiles could also be vulnerable to sabo-

tage of rail lines. Not procuring the additional 50 missiles for mobile basing would also be consistent with an earlier Congressional decision to limit deployment of MX to 50 missiles in existing silos.

Furthermore, this option would limit the number of MX test missiles to 47. The current MX test program is generally consistent with the statistical guidelines furnished by the Joint Chiefs of Staff and is modest compared with test programs for past generations of U.S. ballistic missiles. Moreover, a large reduction in numbers of MX test missiles could greatly reduce confidence in the ability of deployed MX missiles to function in a crisis. On the other hand, 47 missiles would allow minimal testing--36 missiles for the entire Operational Test program and 11 more to test the effects of aging on the missiles. This smaller test program would reduce costs and might be consistent with the small strategic contribution of the currently approved MX program. The 50 MX missiles now being deployed in existing silos would provide less than 1 percent of U.S. warheads that are likely to survive a Soviet attack.

DEF-09 CANCEL V-22 AIRCRAFT DEVELOPMENT

Savings from Admin. Request	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Budget Authority a/	470	640	2,140	2,800	2,550	8,600
Outlays	240	360	530	1,190	1,900	4,220

a. Because budget details were not available, savings do not include potential savings from termination of Army or Air Force requirements.

The V-22, previously known as the JVX, is a new tilt rotor aircraft under development by the Department of the Navy for use by all four services. (Tilt rotor means that the aircraft has rotor blades that can be positioned vertically for taking off and landing and horizontally for forward flight.) The aircraft will be designed to transport 24 people or about 5,700 pounds of equipment at cruising speeds of over 280 miles per hour. Its long maximum range of 2,400 miles should allow it to fly to Europe in the event of war, thus freeing large transport aircraft and amphibious ships for other cargo.

The V-22 aircraft is expected to perform different missions for each of the four services. The Marine Corps has expressed the largest and earliest need, asking for 552 aircraft with delivery beginning in the early 1990s. These aircraft would be used for combat assault--that is, transporting troops and equipment from an amphibious ship to a beachhead--a mission currently being fulfilled by the aging CH-46 and CH-53 helicopters. Air Force requirements call for 80 aircraft in the 1990s for special operations, while the Navy has indicated a need for only 50 aircraft to conduct combat search and rescue. (The Navy, however, may require about 300 aircraft for the anti-submarine warfare mission of finding and attacking enemy submarines.) Army requirements are the least precise of all the services. Recently, the Army indicated that it would procure about 231 aircraft in the mid-1990s, although an exact requirement for this aircraft has not been officially established.

Canceling further development and procurement of the V-22 could save an estimated $470 million in budget authority in 1988 and $8.6 billion over the next five years. Additional savings could be realized in later years. The Marine Corps could continue to rely on the older and less capable CH-46 and CH-53 helicopters currently being used, while considering other helicopters and amphibious landing craft to perform the combat assault mis-

sion in the future. Relying on these older helicopters should not cause operational problems at the present time. The Marine Corps has indicated that, by continuing to replace parts subject to wear, helicopter service lives can be extended indefinitely. The relatively small needs of the other services could also probably be met with other existing helicopters or small fixed-wing cargo aircraft, although Navy needs for antisubmarine warfare could eventually demand development of another aircraft.

Termination of the V-22 also could reduce the number of aircraft models competing for Navy aircraft procurement funds. The Congress is already concerned about the number of Navy aircraft programs now funded at low procurement rates. Thus, if the Navy had to rely on existing aircraft in lieu of the V-22, these aircraft might be procured at more economic production rates, or at least not reduced below the currently planned rates.

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DEF-10 RESTRUCTURE THE ARMY HELICOPTER PROGRAMS

Savings from Admin. Request	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Budget Authority	800	310	320	260	-300	1,390
Outlays a/	270	580	550	500	120	2,020

a. Five-year outlays are higher than budget authority because of the mix of appropriations in this option. The research and development appropriation spends at a much faster rate than procurement. Therefore, research and development outlay savings from cancellation of the LHX program are only partially offset by early spending on procurement to acquire AH-64 and UH-60 helicopters. The balance of procurement outlays would occur beyond the five-year period.

The Army initiated an ambitious new helicopter program in 1982, known as LHX (Light Helicopter Experimental). Beginning in 1992, the Army plans to produce two versions of the LHX, an attack version and an utility or cargo design. According to tentative plans, the Army intends to purchase about 5,000 of these helicopters, primarily as attack aircraft. Total cost for the program, including development and procurement, was recently estimated by GAO at $60 billion, with $400 million programmed for 1988 and a total of $3.3 billion through 1992.

The Army feels that it must develop a new helicopter to replace its aging fleet of existing light attack (AH-1), scout (OH-58), and utility helicopters (UH-1). These models were developed in the early 1960s and are becoming increasingly difficult to maintain. Indeed, by 1990, about 70 percent of the Army's light helicopter fleet will be 20 years old. Furthermore, according to Army planners, these 1960s vintage aircraft will not be able to meet the threat posed by Soviet aircraft in the 1990s. Specifically, the AH-1 helicopter's limited maneuverability makes it vulnerable to Soviet defense systems.

Serious questions, however, have been raised concerning the desirability and feasibility of the LHX program as it is currently structured. The Pentagon's Defense Science Board recently questioned the need for the performance requirements established for the LHX. The Board argued, among other things, that the Army might have overstated its requirements. The Board also questioned the Army's cost estimates for the program and the preliminary production schedule; both were considered optimistic.

This alternative would cancel the LHX program as now conceived and extend the Army's current attack and utility helicopter programs. Savings would be about $800 million in budget authority in 1988 and $1.4 billion over the next five years. Procurement of the Army's current attack helicopter, the AH-64 Apache, which is scheduled to end in 1988 after 593 aircraft have been bought, would continue under this option. The Army has stated that 593 aircraft are less than 25 percent of the requirement for this type of helicopter. This option would continue AH-64 production at a low rate (36 per year) through 1992, resulting in a total procurement of 706 AH-64s, or about 30 percent of the total Army requirement by 1992.

The Army's newest utility helicopter, the UH-60 Blackhawk, is also scheduled to complete procurement before 1992. This option would continue to produce UH-60s through 1992, but at a rate of 48 per year, which is lower than the Administration's plan. As a result, a total of 1,099 UH-60s would be purchased by 1992, compared with the Army's current procurement plan to acquire 1,107 by 1991.

This alternative has the advantage of relying on the proven capability of the Apache and Blackhawk. Improvements to these aircraft to counter evolving Soviet threats could be added, although the costs of such improvements are not reflected in the savings noted above. This option would also ensure a continuing production capacity for attack helicopters. The Army plan would close the only Army attack helicopter production line after producing the Apaches purchased in 1988, with LHX production not planned to begin before 1992. In the 1987 National Defense Authorization Act, the Congress expressed concern about this gap, which would delay U.S. mobilization in the event of war.

DEF-11 DELAY THE ARMY'S DEEP-ATTACK WEAPONS

Savings from Admin. Request	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Budget Authority	230	320	360	160	-40	1,030
Outlays	90	160	210	180	160	800

The Army and Air Force together are developing a Joint Surveillance and Target Attack Radar System (JSTARS) to provide an airborne platform for early warning and detection of ground targets at long range. Targets might include groups of vehicles, communication nodes, and command centers deep in enemy territory. The Air Force is developing the radar and the plane on which it will be mounted, while the Army is responsible for the ground terminals the system will use to receive data from the airborne radar. The Army's ground terminals would also transmit target information to Army weapons that would attack targets found by JSTARS.

The Air Force does not plan to purchase its first JSTARS radar until 1991. The Army, however, began buying JSTARS ground terminals in 1987, which seems premature since no tactical system currently exists that could use the ground terminals. Furthermore, the Army as yet has no weapons that are capable of attacking targets deep within enemy territory. It is, however, developing a system, called the Army Tactical Missile System (ATACMS), designed to attack targets up to 150 kilometers behind enemy lines. But, since the missile cannot find targets without some general idea of target location, purchasing it before the advent of a working JSTARS also seems untimely. This alternative would synchronize the purchase of the Army's JSTARS ground terminals and the ATACMS missile with Air Force procurement of the JSTARS radars. Purchase of the JSTARS ground terminals would be delayed from 1988 to 1991 and ATACMS from 1989 to 1991.

In addition, the Army is developing a sophisticated antitank warhead for its shorter-range Multiple Launch Rocket System (MLRS). The MLRS was designed as a fire suppression weapon to be used primarily against enemy artillery sites up to 30 kilometers away. It was not designed to destroy tanks. In an attempt to counter the Warsaw Pact's superiority in numbers of tanks, however, the Army is planning to outfit MLRS rockets with antitank warheads that would find and subsequently guide themselves

to individual tanks. The Congress has expressed concern that such a program would be expensive and duplicative of other Army programs that are developing artillery-launched antitank rounds. This alternative would, therefore, delete all funding for an antitank warhead for MLRS.

This alternative offers savings without any apparent significant loss in capability. Because the deep-attack concept cannot be implemented effectively until all aspects of the program--the radar, the terminals, and the missiles--are fully functional, delaying the independent lead items would not affect the system's operational capability. The antitank warhead for MLRS appears redundant. Under this option, savings would be $230 million in budget authority in 1988 and $1 billion over the next five years.

DEF-12 LIMIT FUNDING FOR SUPPORTING PROCUREMENT

	Annual Savings (millions of dollars)					Cumulative Five-Year
	1988	1989	1990	1991	1992	Savings
Savings from Administration's Request						
Budget Authority	0	1,590	2,660	3,380	3,460	11,090
Outlays	0	430	1,180	2,070	2,730	6,410
Savings from CBO Baseline						
Budget Authority	1,880	1,350	750	80	-660	3,400
Outlays	500	910	1,050	770	170	3,400

Most Congressional debate over the defense budget revolves around major defense programs that buy missiles, aircraft, and ships. Such spending accounts for about 71 percent of total appropriations for procurement. Another 24 percent--labeled here as "supporting procurement"--is spent for trucks and cars, communications equipment, general purpose computers, office equipment and furnishings, training devices, and the variety of other equipment required by the military services. These items support the operational needs of the services both in the field and at headquarters. In terms of mission importance, they range from items essential to military operations, such as sonobouys or radios, to items more related to administrative activities common to peacetime and wartime, such as office computers.

In 1987, the Congress reduced the Administration's request for an 18.8 percent real increase in budget authority for supporting procurement to 2.7 percent. In its 1988 budget, the Administration has requested $19.4 billion, a decrease of 5.2 percent from the 1987 appropriation. This is a real decline of close to 9 percent, when expected inflation is taken into account. A real increase of nearly 12 percent, however, is requested in 1989. This option would target no further reduction in the supporting procurement accounts for 1988; these accounts could then be allowed to grow at a 3 percent real rate in subsequent years. This action would reduce spending by $11.1 billion over the 1989-1992 period, relative to the Administration's request, and by $3.4 billion relative to the CBO baseline.

Because these accounts buy a multitude of equipment items, this report cannot specify the detailed changes needed to achieve the savings discussed above. In the past, the Congress has tended to cut funds for communications equipment, munitions, and industrial preparedness by larger amounts, while providing most of the requested funds for items such as spare parts, vehicles, and base support equipment. If this pattern was followed in limiting the 1989-1992 requests, the major effects would be a slowing of communications modernization and less ability to sustain combat in the event of an extended conflict. Normal peacetime operations and immediate combat readiness would be less affected.

DEF-13 ALTER RESEARCH AND DEVELOPMENT FUNDING

	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1988	1989	1990	1991	1992	
Savings from Administration's Request						
Budget Authority	6,350	5,370	-790	-2,340	-1,370	7,220
Outlays	3,250	5,010	1,920	-990	-1,460	7,730
Savings from CBO Baseline						
Budget Authority	0	0	0	0	0	0
Outlays	0	0	0	0	0	0

Although Congressional and public attention has focused on the Strategic Defense Initiative (see DEF-14), research and development (R&D) appropriations for the Department of Defense pay for a wide range of other activities: basic research, such as high-energy physics or microbiology; applied research, such as ceramic or construction engineering; engineering development to put weapons systems into production; and operational testing of newly developed weapons. Although most defense R&D funds are spent in private industry for the development of weapons systems, these funds also finance the operation of government laboratories and much research activity at universities and private nonprofit research centers.

The adequacy of R&D funding is difficult to measure; the potentially adverse effects of lower spending levels would not manifest themselves for several years. Much of the research funding is spent to explore new technologies, only some of which lead to advanced research and development. Increases in real levels of research funds should allow continued exploration of new areas; lower spending levels would require greater scrutiny of new research proposals and harder choices about the continued funding and rate of funding for ongoing programs. At some point, tighter research budgets would result in further narrowing of the U.S. technological advantage over the Soviet Union.

R&D budget authority has grown sharply in recent years, up by 96 percent in real terms from 1980 through 1987. This corresponds to an average annual real growth of about 10 percent. The Administration requested

$41.9 billion in 1987 (a real increase of 21 percent), but the Congress appropriated only $35.8 billion, a 3 percent increase in real funding compared with the previous year.

For 1988, the Administration has requested 17 percent real growth in budget authority for R&D. The Congress could choose to provide zero real growth in R&D funding (only enough to allow for inflation) in 1988 and subsequent years. This option would save $6.4 billion in budget authority in 1988 and $7.2 billion over the next five years relative to the Administration's request. There would be no savings relative to the CBO baseline under this option. This option would allow the same level of R&D effort as in 1987 and would leave R&D with about 12.4 percent of the entire defense budget, a high level by historical standards.

Because so many programs exist in this area, this report cannot specify which programs would be affected by a slowdown. Last year, for example, the Congress made detailed changes to hundreds of different R&D programs. The Strategic Defense Initiative and research on a new, small ICBM would probably be affected by any major slowdown in R&D funding, as would many smaller programs.

DEF-14 SLOW GROWTH IN THE STRATEGIC DEFENSE INITIATIVE

Savings from Admin. Request	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Budget Authority	1,200	1,500	1,700	2,000	2,300	8,700
Outlays	540	1,170	1,460	1,740	2,020	6,930

On March 23, 1983, President Reagan called for the United States to render nuclear weapons "impotent and obsolete" by developing defenses that could destroy an enemy's nuclear weapons before they exploded on American soil. The research and development (R&D) plan resulting from this mandate--known as the Strategic Defense Initiative (SDI)--calls for devoting about $37 billion from 1988 through 1992 to study applicable technologies and system concepts, ranging from space-based lasers and particle beam weapons to more conventional antiballistic missiles.

The pace of SDI funding will determine how quickly SDI moves from a research to a development program. Some advocates argue that this pace should proceed as quickly as the fastest technological advances would allow. Others argue that SDI should not proceed beyond intensive research without greater understanding of how SDI would be integrated into the overall U.S. defense posture--including offensive forces, arms control, and allied responsibilities. For example, preserving the Anti-Ballistic Missile treaty is a widespread concern in the Congress. Still a third group argues that only a particular focus of SDI should proceed as fast as possible, such as tactical ballistic missile defense or terminal defense of intercontinental ballistic missiles.

Meanwhile, there is a growing concern that SDI budgets will overwhelm other, very important research and development efforts. The Administration's plan calls for a steep rate of real growth in SDI funding: 35 percent from 1987 to 1988 and an average of 14 percent annually thereafter through 1992. Thus, the SDI will consume a greatly increasing share of Department of Defense R&D resources. In 1985, the first year of the SDI program, it represented about 5 percent of the Research, Development, Test, and Evaluation (RDT&E) budget. By 1992, the SDI would take up about 23 percent of the total DoD RDT&E budget.

Concerns about technological balance and the pace of SDI growth could be partly addressed by slowing the rate of growth in spending (in real terms) during the next five years. This slowdown would save $1.2 billion in budget authority in 1988 and $8.7 billion over the next five years. Under this plan, the SDI would still consume about 18 percent of the DoD RDT&E budget by 1992. Remaining funding should allow intensive evaluation of the feasibility of new SDI technologies, and full-scale development and deployment decisions could still be pursued in the 1990s. This slowdown would also allow more time to develop this large program efficiently and to debate fully the technical and arms control issues involved in these efforts. But, under this alternative, the SDI is not likely to be deployed as early or as completely as under the Administration's plan, a major drawback in the view of ardent SDI supporters.

DEF-15 ALTER FUNDING FOR MILITARY CONSTRUCTION

	Annual Savings (millions of dollars)					Cumulative Five-Year
	1988	1989	1990	1991	1992	Savings
Savings from Administration's Request						
Budget Authority	1,550	1,670	2,070	2,140	2,710	10,140
Outlays	200	850	1,310	1,710	1,920	5,990
Savings from the CBO Baseline						
Budget Authority	200	200	210	220	220	1,050
Outlays	30	110	160	190	190	680

Military construction funding for the Department of Defense pays for a wide range of activities: combat-related construction, such as ammunition storage facilities and aircraft and weapons maintenance facilities; morale- and welfare-related construction, such as gymnasiums and child-care centers; and living accommodations, such as unaccompanied personnel housing and barracks. These funds also pay for acquiring land for military use and for modifying existing facilities.

Military construction funding increased by an average of over 10 percent annually in real terms from 1980 through 1986. In 1987, however, the Congress reduced real budget authority for this purpose to 8 percent below the 1986 appropriated level. In 1988, DoD has asked for $6.6 billion in budget authority for military construction, a real increase over the 1987 level of 25.9 percent. If this request was restricted to the 1987 appropriated level, and held constant in real terms in subsequent years, this option would save $1.6 billion in budget authority in 1988 and $10.1 billion over the next five years relative to the Administration's request. This option would save $0.2 billion relative to the CBO baseline in 1988 and a total of $1.1 billion over the next five years.

Potentially adverse effects of continuing to limit the growth in military construction are difficult to assess because of the large number of projects in this area, each of which could be affected differently. Some projects would probably take longer to complete, while some planned military construction programs would probably be canceled or postponed indefi-

nitely. Even some new projects that have received strong support from the services--such as military construction programs at Ft. Drum, New York, to support one of the Army's new divisions and the Navy's plan to establish new homeports for some of its fleet--might have to be reduced in their scope unless spending for other projects was lowered to offset the cost of the new programs.

DEF-16 RETIRE SOME G-MODEL B-52 STRATEGIC BOMBERS EARLY

Savings from Admin. Request	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Savings in Total Federal Budget a/						
Budget Authority	280	870	1,220	1,280	1,340	4,990
Outlays	130	480	820	1,000	1,220	3,650
Savings in Defense Budget a/						
Budget Authority	280	870	1,220	1,280	1,340	4,990
Outlays	150	550	910	1,100	1,230	3,940

a. Savings in the federal and DoD budgets differ because of the effects of accrual accounting applied in the defense budget to retirement costs of military personnel.

The bulk of the current strategic bomber force consists of the G and H models of Boeing B-52 aircraft, introduced into the force in the 1960s. Continuing improvements in Soviet air defenses have limited the ability of these bombers to penetrate Soviet airspace. To address this problem, the Administration has been installing air-launched cruise missiles on B-52s, is going to field new B-1B bombers over the next few years, and plans to introduce an advanced technology--or "stealth"--bomber (ATB) at a later time.

Cruise missiles are small, highly accurate, unmanned missiles that can be launched outside Soviet airspace, thus allowing the bomber to remain beyond the range of most enemy air defenses. These missiles are now deployed on 90 of 151 B-52G aircraft, and the 90 newer B-52H aircraft are being modified to carry these missiles. B-52Gs not modified to carry cruise missiles will be transferred from the strategic forces and used as conventional bombers.

The Administration plans to retire B-52Gs that carry cruise missiles in the mid-to-late 1990s, as the ATB is fielded. This option would retire these aircraft by 1990 as the B-1Bs are deployed. Operating and support savings would equal $280 million in budget authority in 1988 and nearly $5 billion

over the next five years. These savings include funds that would have been used to modify these aircraft. Although the bomber force would be somewhat smaller than its current size for a few years, numbers would rise somewhat above current levels as the ATB is deployed. Retiring these B-52G aircraft early would also reduce demand for tankers for aerial refueling, thus easing the shortfall for that aircraft.

There would be another advantage as well. The SALT II treaty limits to 1,320 the numbers of multiple warhead missiles and bombers carrying air-launched cruise missiles (ALCMs); a further sublimit constrains the number of multiple warhead missiles to 1,200. If other forces are introduced as planned, having more than 120 bombers carrying ALCMs would require compensatory reductions in multiple warhead missiles. Although the Administration is no longer adhering to the unratified SALT II treaty, the Congress formally expressed its sense that the United States should continue to adhere to the numerical sublimits so long as the Soviet Union continued to do so. If older B-52Gs were retired early, all B-52Hs and some B-1Bs could be modified to carry cruise missiles without exceeding these limits. Modernization would not cause the United States to bump up against the SALT limits again until September 1988, when the ninth Trident submarine is scheduled to begin sea trials.

DEF-17 ALTER OPERATION AND MAINTENANCE FUNDING

	Annual Savings (millions of dollars)					Cumulative Five-Year
	1988	1989	1990	1991	1992	Savings
Savings from Administration's Request						
Budget Authority	2,430	2,540	2,720	2,870	3,010	13,570
Outlays	1,840	2,430	2,640	2,790	2,930	12,630
Savings from CBO Baseline						
Budget Authority	-830	-2,260	-5,890	-8,510	-10,810	-28,300
Outlays	-630	-1,880	-4,940	-7,710	-10,060	-25,220

About 27 percent of 1987 defense appropriations supports the operation and maintenance (O&M) of existing plant and equipment. Part of this account pays for civilian workers. The rest purchases goods and services for maintenance of existing equipment, training, fuel and spare parts, base operations, and many other things. Spending for these activities is commonly referred to as "readiness" spending since it contributes directly to the day-to-day capability of the military forces.

Since 1982, O&M budget authority has increased about 16 percent in real terms. Although some of this growth was needed to support an increase in forces for both the Navy and Air Force, much of it, according to the Department of Defense, was used to increase the readiness and training of forces that already existed. Current budget plans call for O&M budget authority to increase about 15 percent in real terms during the next five years. Presumably this higher funding stems from the cost of operating new equipment and of placing current forces at an even higher state of combat readiness and effectiveness.

These increases in O&M could be appropriate if history is a guide. The total value of all defense weapons will increase at an average rate of about 3 percent annually in real terms through 1992, assuming that the Administration carries out its current defense plans. Over the last 10 years, O&M has correlated reasonably closely with the total value of weapons. If this relationship continues, demands for O&M could increase.

On the other hand, substantial increases in O&M would not be needed if the services limited their O&M spending per weapon in the future to what they spend today. Based on five-year force structure and modernization plans submitted by DoD, CBO estimates that planned changes would require an average real increase of about 1 percent in O&M spending over the next five years, if spending per weapon remained unchanged. Because DoD claims that current forces are at a high level of readiness, it is not unrealistic to assume that the current level of spending per weapon is adequate.

If improvements to date in force readiness were deemed sufficient, growth in real O&M funds could be slowed. In 1987, the Congress reduced the Administration's request in budget authority for O&M by about 9 percent which resulted in about 2 percent real growth in budget authority over the 1986 level. In addition, the Congress agreed to refunds from the various service stock funds to the operation and maintenance accounts. These refunds are not figured into the real growth figure. Limiting the O&M funding to 1 percent real growth in 1988, and then allowing it to increase at rates proposed by the Administration in subsequent years, would save $2.4 billion in budget authority in 1988 and a total of $13.6 billion over the next five years relative to the Administration's request. Relative to the CBO baseline, this option would exceed the baseline by $0.8 million in fiscal year 1988 and by $28.3 billion over the next five years. This might require reducing some operating tempos relative to the Administration's planned level, unless operating and maintenance efficiencies could be realized. CBO cannot specify in detail the effects of such a limit because of the large number of O&M projects, each of which could be affected differently.

DEF-18 REDUCE ACTIVE-DUTY END STRENGTH TO 1982 LEVEL

Savings from Admin. Request	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Savings in Total Federal Budget a/						
Budget Authority	390	1,380	2,280	2,880	3,010	9,940
Outlays	260	930	1,580	2,020	2,160	6,950
Savings in Defense Budget a/						
Budget Authority	410	1,440	2,370	3,000	3,150	10,370
Outlays	380	1,400	2,340	2,960	3,140	10,220

a. Savings in the federal and Department of Defense budgets differ because of the effects of accrual accounting applied in the defense budget to retirement costs of military personnel and in the treatment of social security withholdings.

Since 1980, active-duty end strength (the total number of active-duty military personnel at the end of the fiscal year) has increased by 6.6 percent, from 2,040,000 in 1980 to 2,174,000 authorized for 1987. Much of this increase was used for expanded forces in the Navy and the Air Force. For example, in 1980 the Navy had a total of 479 battle force ships, including 13 deployable aircraft carriers. In 1987, the number of battle force ships will reach 567, an increase of 18 percent, with 14 deployable aircraft carriers. Similarly, the Air Force increased the number of its tactical fighter wings from 34 in 1980 to 37 in 1987.

It isn't clear that the Administration's national security policy requires this increase in forces. Rather than follow previous approaches in planning capabilities to fight one major war--or one major war plus a separate minor conflict--this Administration has been less specific about its strategy for conventional forces. Recently, however, Secretary Weinberger has indicated that the Administration's conventional strategy is not so different from the strategy of previous Administrations.

Moreover, budget constraints have not allowed the Administration to achieve all of its original force goals. Although the Navy expects to achieve a numerical goal of 600 ships by the end of fiscal year 1989 when new ships already funded by the Congress will join the fleet, it will be an older fleet and a different mix than originally planned. Nor has the growth in active-duty manpower for the Navy kept up with what would be needed to man the

600 ships fully while maintaining what the Navy would consider a desirable rotation between sea and shore duty. The Air Force goal of 40 tactical fighter wings by 1986 was revised downward to maintain the current 37-wing structure. The Army increased its total number of active force divisions from 16 to 18 by decreasing the size of previously existing divisions and transferring some support responsibilities from the active to the reserve forces. Thus, the Administration would argue that the further increases in personnel and force structure proposed in its budget are necessary to meet defense needs.

On the other hand, if efforts to reduce the budget deficit constrained future defense budgets below today's levels, current active-duty end strength might be reduced. Overall spending reductions might lead to reductions in personnel in order to maintain at acceptable levels the spending for high-priority programs for research and procurement--such as the Advanced Technology Bomber (ATB), Advanced Tactical Fighter (ATF), and the Strategic Defense Initiative (SDI)--and to retain spending for day-to-day operations at about today's level.

One alternative would be to reduce active-duty end strength by 75,000 below the 1987 level over the next two years, leaving it at about the level authorized in 1982. Immediate savings under this alternative in the personnel accounts would be $390 million in budget authority in 1988 and $9.9 billion over the next five years, assuming the reductions are applied proportionally and at all pay grades. These savings reflect reduced costs for personnel and personnel support. Even when the reduction was implemented fully, however, the cuts would amount to about 1 percent of the total defense budget, far less than the 3.5 percent reduction in personnel.

Achievement of further cost savings would depend on how the reductions were accommodated. Reductions of this magnitude could require changes in the force structure. For example, the Navy would be hard pressed to man all of its ships and might have to retire many ships earlier than planned. The number of deployable aircraft carrier battle groups might fall to 13, the number that existed in 1982. The Air Force might have to reduce to 36--the 1982 level--the number of tactical fighter wings and retire some B-52s early (see DEF-16). The Army could deactivate two divisions, returning to the 16 active divisions that existed before 1985. These reductions in force structure should eventually lead to substantial reductions in procurement costs as fewer weapons are needed. Such reductions might take several years, however, since much of the procurement planned in the next few years would be needed to modernize the forces that would remain even after the cuts called for in this option. Moreover, some of the personnel reductions under this option could be accomplished by reducing overhead

rather than fighting units, which would not lead to procurement savings even in the long run.

Nevertheless, force changes of this magnitude would inevitably reduce defense capabilities. The number of ships actively deployed at any given time during peacetime would be reduced from current levels. In the event of a major war with the Soviet Union, there would be fewer tactical air and combat ground forces than there are today. No one can assess precisely the effect this would have on the outcome of a major war in Europe, but it would add risk. Force levels would still match those that existed in 1982, however, and by most measures offered by DoD, the quality of the forces today is higher than it was at that time. Thus, although defense capabilities under this option would be lower for some contingencies, they would exceed the 1982 levels.

In addition, the losses in capability caused by reductions in end strength would be mitigated somewhat by the productivity-enhancing effect of increased seniority in the services' enlisted forces. Average experience is increasing in all the military services. Evidence on experience/productivity trade-offs in the military is limited, but what evidence is available suggests that increases in seniority could offset roughly one-third to one-half of this option's cuts in enlisted end strength in terms of aggregate effectiveness. This result assumes that the cuts would affect all years of service equally, the same assumption underlying the above cost figures. If, instead, the cuts were accomplished entirely through reduced recruitments in fiscal years 1988 and 1989, the offset would be on the order of 60 percent to 80 percent, with some reduction in cost savings. While increased productivity would not necessarily affect the force reductions required because of cuts in end strength, it would make the remaining forces more effective than they currently are.

DEF-19 SLOW THE GROWTH IN ARMY ACTIVE GUARD AND RESERVE PERSONNEL

Savings from Admin. Request	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Savings in Total Federal Budget a/						
Budget Authority	70	220	390	600	840	2,120
Outlays	50	150	270	420	600	1,490
Savings in Defense Budget a/						
Budget Authority	70	230	410	620	870	2,200
Outlays	70	220	400	610	850	2,150

a. Savings in the federal and DoD budgets differ because of the effects of accrual accounting applied in the defense budget to retirement costs of military personnel and in the treatment of social security withholdings.

Army Active Guard and Reserve (AGR) personnel are full-time military members who are assigned to reserve components. In the event of war, they would join their part-time reserve units as full-time soldiers. The AGR personnel levels generally increase to support specific units and missions as reserve components expand. To accompany its proposed growth in the Army Reserve and Army National Guard, the Administration's plan calls for an increase in Army AGR personnel from 37,467 in 1987, or 4.9 percent of Army total reserve strength, to 55,450 in 1992, or 6.5 percent of total strength.

Active Guard and reserve personnel fill an important need. They perform a variety of administrative tasks, including the management of equipment maintenance and coordination of training programs so that, when part-time reserve personnel serve on weekends, they can concentrate on training. Nor are the numbers of Army AGR personnel out of line with the other services. About 4.9 percent of the total strength of the Army National Guard and Army Reserve are made up of AGRs, compared with 14.9 percent in the Navy Reserve and 4.6 percent in the Air National Guard and Air Force Reserve.

On the other hand, AGR personnel are generally more expensive than typical active-duty soldiers since they have more military experience. Last

year, the Congress reduced the number of full-time reserve personnel below the level proposed by the Administration. The Congress could again alter the funding for AGR personnel by maintaining it at the 1987 authorized level over the next five years. This would save $70 million in budget authority in 1988 and $2.1 billion over the next five years. To the extent that AGRs are necessary to maintain reserve readiness, this approach could increase some units' administrative workloads at the headquarters level and lower some maintenance standards for vehicles and equipment.

DEF-20 LIMIT MILITARY PAY RAISE

Savings from Admin. Request	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Savings in Total Federal Budget a/						
Budget Authority	950	1,300	1,350	1,400	1,460	6,460
Outlays	610	910	970	1,010	1,060	4,550
Savings in Defense Budget a/						
Budget Authority	990	1,350	1,410	1,470	1,520	6,740
Outlays	920	1,330	1,410	1,460	1,520	6,640

a. Savings in the federal and DoD budgets differ because of the effects of accrual accounting applied in the defense budget to retirement costs of military personnel and in the treatment of social security withholdings.

Under current law, military personnel will receive an annual pay raise in October 1987 that matches the change in private-sector pay. The Administration proposes instead a 4 percent increase effective January 1, 1988. This increase would be similar to the raise assumed in the CBO baseline, which is designed to keep pace with private-sector wage increases since the last military pay raise. Such a raise might not, however, be justified considering the recent strength of recruitment and retention. A 2 percent January increase, coupled with increased spending on first-term reenlistment bonuses as described below, would satisfy many of the purposes of the larger proposed increase at considerable savings. Budget authority would be reduced by $950 million from the Administration's request in 1988, and by $6.5 billion over the next five years (assuming that annual raises after 1988 kept pace with those in the private sector, without any adjustment to recoup the 1987 loss).

The 2 percent raise would represent a compromise between the dictates of pay *comparability* and pay *competitiveness*. In the long term, comparability must be maintained or the services will risk losing their best people to higher private-sector pay. Short-run deviations from comparability may be justified, however, when recruitment and retention conditions are particularly good or bad. The Administration's request would maintain current levels of comparability. Recent retention and recruitment

successes--indicated by first- and second-term reenlistment rates near historical highs and continued high percentages of enlistments by those with high aptitudes and high school diplomas--suggest, however, that a more modest pay increase could give the services a sufficiently strong competitve position to meet their needs. No increase at all, on the other hand, might erode the confidence of service personnel in the long-term commitment by the Congress to pay comparability.

Reduced first-term reenlistment rates resulting from the smaller pay raise could cause a problem. Although the rates would remain high by historical standards, the small number of people entering the service in past years will lead to smaller than usual numbers of second-term service people in the next few years (and eventually, to smaller numbers progressing into the senior career force). If this problem became severe, spending on first-term reenlistment bonuses might have to be increased. A $150 million increase would offset the effect of the less-than-comparable pay raise, and improve the services' abilities to correct imbalances across military occupational specialties. This added spending is not reflected in the above figures.

Selectively adding to the pay of service members beginning their second enlistment tours would contribute to "pay compression"--that is, a reduced pay differential between senior and junior personnel. Although senior service personnel who were unhappy about this compression might not leave in large numbers, they could lose motivation and become less productive. It also is possible that the extra personnel retained by higher first-term bonuses would tend to leave upon completing their additional obligated service. Whether this effect would be undesirable would depend on the services' future requirements for senior career personnel.

DEF-21 RAISE COST-SHARING FOR CERTAIN OUTPATIENTS

Savings from Admin. Request	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Budget Authority	110	120	120	130	130	610
Outlays	90	110	120	120	130	570

Several categories of patients receive free care at military outpatient clinics, including dependents of active-duty personnel, retired military personnel, and dependents of retirees. This option would save $70 million in budget authority in 1988 and $410 million over the next five years by charging all but dependents of low-ranking enlisted personnel (E-4 and below) for most outpatient visits made in the continental United States. It would save an additional $40 million in 1988 and $200 million over the five years by doubling the annual deductible under the Civilian Health and Medical Program of the Uniformed Services (CHAMPUS). This fee has not changed since 1966. (Administrative expenses not included in these estimates would offset some of these savings, but the offset should be modest if the military adapts existing or planned automated health information systems to track the fees.)

Under this option, dependents of enlisted personnel above pay grade E-4 and retired enlisted personnel and their dependents would pay $5 for each visit to a military-sponsored clinic. Retired officers and their dependents, as well as dependents of active officers, would pay $10. Total charges would be limited to $100 a year for each enlisted family member and $200 for each officer family member. The annual CHAMPUS deductible would rise to $100 for an individual or $200 for a family.

Charging outpatients would help the Department of Defense defray the $58 it spends on average for each outpatient visit. It would also reduce the demand for scarce medical services. People tend to overuse free medical services, thus contributing to overcrowding in military clinics. Reduced clinic services would benefit DoD by freeing resources for use in other areas, such as inpatient care. Moreover, this option would give military beneficiaries an incentive to participate in DoD's new voluntary CHAMPUS Reform Initiative (which will use special networks of civilian medical providers) by raising the cost of continuing to receive outpatient care in mili-

tary facilities or through the current CHAMPUS program. (The Administration is planning to collect nominal fees from some non-active-duty outpatients on a limited test basis; potential savings, however, do not appear in the President's budget.)

Because of medical care's importance as a part of military compensation, military families might view an outpatient charge as an erosion of benefits. Recruitment and especially retention could suffer, although the parallel trend in civilian medicine towards greater cost sharing might limit dissatisfaction by military personnel. Indeed, findings from the department's 1984 health-care survey suggest that many enlisted families would accept a $5 fee: if they had to pay that amount, 60 percent of the outpatients from active enlisted families and 80 percent from retired enlisted families would still have wanted to visit a military physician. Nor should a fee significantly harm health, a concern of some, since evidence shows that people at ages and incomes typical of military beneficiaries seek necessary medical care even when they must share the costs.

ENTITLEMENTS AND OTHER MANDATORY SPENDING

Entitlements and other mandatory spending represent the largest single category of federal spending. Excluding agricultural price supports, which this report considers in a separate section, entitlement outlays equalled 44 percent of federal outlays in 1986. 1/ If no changes are made in current policies, spending for entitlements is expected to increase from $432 billion in 1986 to an estimated $642 billion in 1992, or 49 percent of total outlays. This chapter presents 21 options that would either reduce outlays for entitlements and other mandatory spending or would increase general or earmarked revenues--for entitlement-related functions--compared with the CBO baseline.

Entitlement programs provide benefits to all people or jurisdictions who are eligible to receive aid and who choose to participate. The level of spending in entitlement programs is determined, not by the annual appropriations process, but rather by the program rules that govern eligibility and the extent to which eligible persons or entities participate. As a result of a variety of factors--including demographic shifts, changes in provider practices, and cost-of-living adjustments (COLAs)--outlays for entitlements vary automatically. To curtail the growth in spending for these programs, the Congress must modify the laws governing an entitlement program's eligibility, benefits, or reimbursement of providers for their services.

As Figure 4 indicates, Social Security is the largest entitlement program, accounting for 46 percent of federal spending on nonfarm entitlements in 1986; other federal retirement and disability programs constituted an additional 11 percent. Medicare, the second largest entitlement pro-

1. All figures on spending for entitlement programs exclude agricultural price supports because this report considers farm price supports in a separate section. Including agricultural price supports, entitlements equalled 46 percent of federal spending in 1986 and would grow to an estimated 51 percent of outlays in 1992, if no changes are made in current policies. For a detailed breakdown of entitlement spending by program, including agricultural price supports, see Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1988-1992* (January 1987), Table II-7, p. 60.

gram, represented 17 percent of spending for entitlements, while other non-means-tested programs--including Unemployment Insurance and veterans' benefits--accounted for 10 percent of these outlays. Medicaid, Food Stamps, Supplemental Security Income, and other means-tested programs made up the remaining 16 percent.

In 1986, approximately one-quarter of entitlement spending went for health programs and three-quarters for non-health programs (see Figure 5). Almost 75 percent of health expenditures were payments for hospital, physician, or other services for Medicare beneficiaries; 25 percent were grants to states for services for Medicaid beneficiaries.

Through the mid-1970s, outlays for nonfarm entitlements grew rapidly as a result of the creation of new entitlement programs and major expansions in eligibility and benefits in both new and already existing programs. Entitlements rose from $33 billion in 1965 to $183 billion in 1976; after accounting for inflation, spending tripled in this period (see Figure 6).

Figure 4.
Composition of Entitlement Outlays by Type of Program, 1986

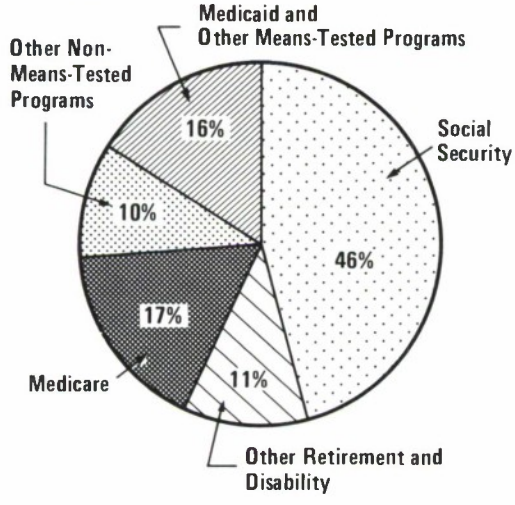
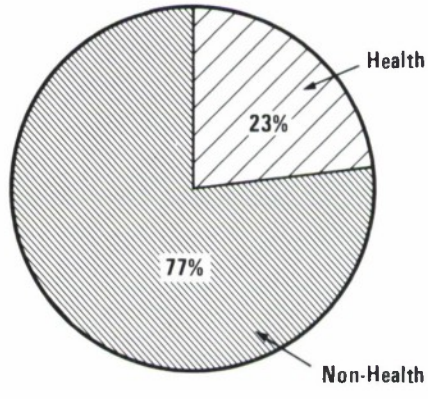


Figure 5.
Composition of Entitlement Outlays by Type of Expenditure, 1986

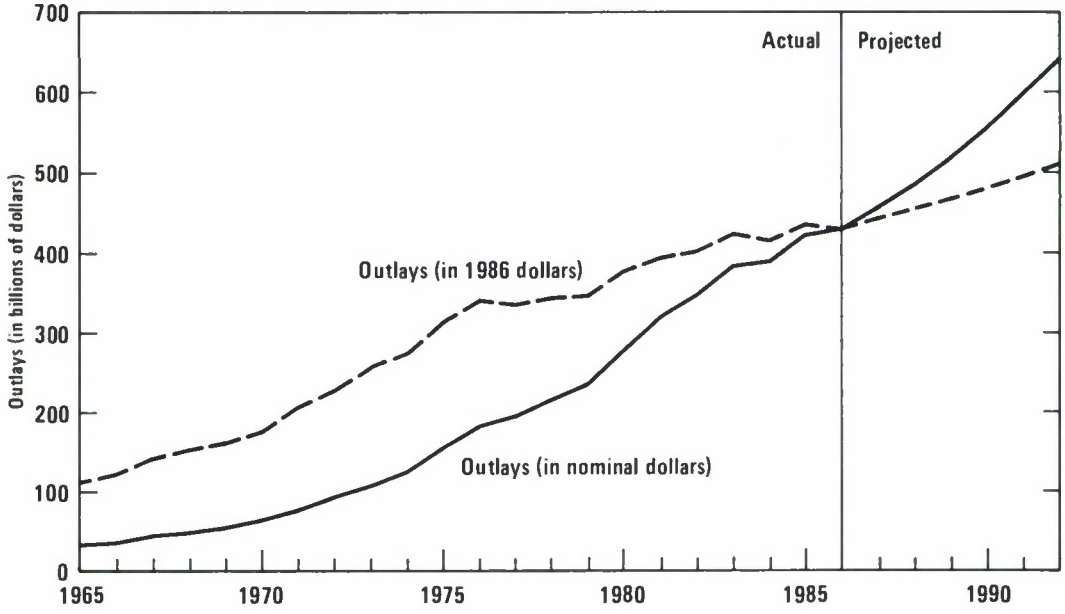


SOURCE: Congressional Budget Office.
NOTE: Figures exclude agricultural price supports.

Although growth in entitlement spending slowed after the mid-1970s, outlays continued to increase. Spending for entitlement programs rose from $183 billion in 1976 to $432 billion in 1986--a 27 percent increase in real terms. Since 1981, legislative actions to slow this growth have been substantial, but, because of phase-in periods, for example, the effects of many changes could be seen only after a lapse of time. Moreover, despite these legislative changes, CBO projects that entitlements will grow more rapidly than overall inflation and will remain about the same proportion of the gross national product over the next five years.

Spending for health programs has grown more rapidly than spending for other entitlements (see Figure 7). While demographic changes--the increased elderly population, for example--have affected both types of entitlements in roughly the same way, health-care benefits per person have risen more rapidly than non-health benefits. A main reason for this differential growth is that health-care prices have risen, and are expected to continue to rise, more rapidly than other prices. For example, the medical care services component of the Consumer Price Index (CPI) rose by 49 percent between 1981 and 1986, while the overall CPI increased by only 23 percent during the same period. In addition, the average beneficiary's use of

Figure 6.
Entitlement Outlays, 1965-1992



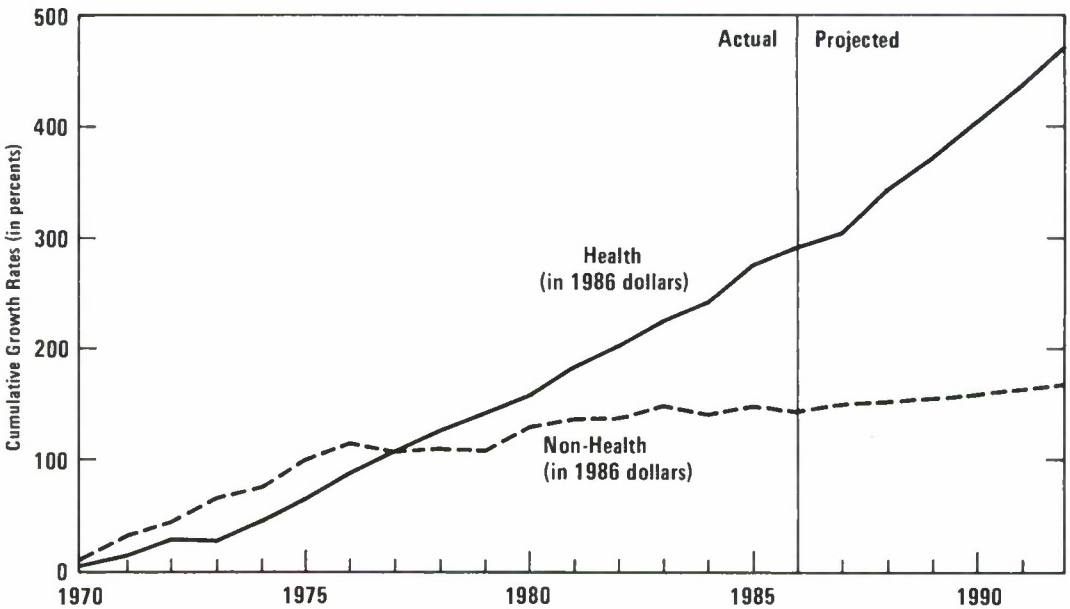
SOURCE: Congressional Budget Office.
NOTE: Figures exclude agricultural price supports.

health-care services--often called intensity--has risen over the same period. Looking to the future, the CBO baseline assumes that these underlying conditions will continue and, therefore, that spending for health entitlements will grow more rapidly than the remainder of this budget category.

During the past year, the Congress curtailed slightly the growth in aggregate spending for entitlement programs; eliminating the over $4 billion General Revenue Sharing (GRS) program was the largest spending change. In other cases--Medicare, Guaranteed Student Loans, and Medicaid, for example--program expansions were enacted at the same time as other options to reduce federal costs, with only a small net effect on federal spending. In several programs--Social Security being the largest--recipients received an unscheduled cost-of-living adjustment (COLA) in January 1987 because the provision that defers COLAs when inflation is low was eliminated. The overall result of all changes in entitlement programs, including the 1986 sequestration, is that total outlays were reduced, compared with the CBO baseline, by about $5 billion in 1987 and approximately $6 billion in 1989, or about a 1 percent reduction in spending for entitlement programs. In addition, federal revenues increased because the maximum wage base for Social Security taxes increased with the unscheduled COLA.

Figure 7.

Cumulative Growth Rates in Entitlement Outlays by Type of Expenditure, 1970-1992



SOURCE: Congressional Budget Office.
NOTE: Figures exclude agricultural price supports.

The Congress could curtail the growth of spending in entitlement programs in three main ways--limiting payments to providers, reducing or eliminating aid to beneficiaries, or increasing receipts. The options presented in this chapter include examples of each approach.

The first way--altering payments to providers of services for beneficiaries--has been used extensively in the past, especially in the Medicare program. Some changes in payments to health-care providers might not affect recipients; other changes, especially substantial ones, could affect beneficiaries adversely--reducing their quality of care or increasing their expenditures, for example. ENT-01 through ENT-04 would limit Medicare's payments to hospitals; ENT-05 and ENT-06 would reduce payments for physicians' services.

Alternatively, the Congress could cut spending by eliminating eligibility for certain groups felt to be less in need or by reducing benefits for some or all program recipients. ENT-14 through ENT-18 are examples of this approach.

Under the third approach, the Congress could increase receipts either from current beneficiaries (ENT-07 through ENT-11) or from broad groups of taxpayers (ENT-13, ENT-19 through ENT-21). The former set of options would reduce federal costs by requiring recipients to pay more; the latter set would increase general or earmarked revenues. In addition, some of the options would reduce the use of services, especially health-care services. ENT-12 is a hybrid approach because it would reduce federal payments to states that could in turn cut payments to providers, limit benefits, raise revenues, or use some combination of these three approaches. Several other options to increase revenues for entitlement-related functions (REV-18 through REV-20) are discussed in the revenue section of this report.

In this section, options to reduce spending for entitlement programs or to increase revenues are organized by program area. ENT-01 through ENT-13 concern health-care programs. ENT-14 through ENT-16 discuss alternatives for reducing net federal outlays for Social Security and other retirement and disability programs. ENT-17 through ENT-21 address other entitlement programs.

ENT-01 RECALCULATE MEDICARE'S PROSPECTIVE PAYMENT RATES USING MORE RECENT COST DATA

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Reduce the Payment Rates by 10.1 Percent						
Outlays	4,400	4,850	5,400	5,950	6,600	27,200
Reduce the Payment Rates by 7.1 Percent						
Outlays	3,050	3,350	3,750	4,150	4,550	18,900

The Social Security Amendments of 1983 established the current prospective payment system (PPS) under which Medicare reimburses hospitals for inpatient services provided to beneficiaries. Payment rates are set in advance for each of 471 diagnostic categories known as diagnosis-related groups (DRGs). By the end of fiscal year 1988, all payments to hospitals will be based on national rates, calculated separately for urban and rural areas, using 1981 cost data that had been inflated to represent 1984. For fiscal years 1985 to 1987, the rates were updated annually by the Secretary of the Department of Health and Human Services (HHS) and by the Congress. Actual cost data for 1984 have just recently become available.

The new data provide information that could be used both to make technical adjustments to the PPS rates and to evaluate the overall generosity of the system. Because a system that incorporated the technical adjustments would more accurately reflect the situations of hospitals when the PPS began, many analysts urge the adoption of these adjustments--a change often referred to as "rebasing" the system. A simple approach that would address technical difficulties with the relative rates now paid to urban and rural hospitals would be to replace the 1981 data with those from 1984, but leave all other components of the pricing system--for example, the "update factors" for 1985 through 1987--at their historical values. In this case, the rebased rates would be 10.7 percent lower for urban hospitals and 7.3 percent lower for rural hospitals (for a weighted average of 10.1 percent), reflecting the cost reductions hospitals had achieved by 1984 rela-

tive to what had been expected based on pre-PPS costs. The new rates would not, however, incorporate any further improvements in efficiency or make any other technical adjustments to the PPS system. (See, for example, ENT-02 which describes a possible modification to the indirect teaching adjustment.)

If these rebased rates were implemented, Medicare's outlays would be reduced by $27.2 billion during the 1988-1992 period. While there is general agreement that relative rates should be recalculated using the 1984 data, more controversy surrounds the question of whether the level of aggregate Medicare payments to hospitals should be reduced at the same time.

Proponents of lowering total payments when rebasing the system argue that it is currently too generous, in part because hospitals have reduced their costs substantially both before and after the implementation of the PPS. During the past few years, the Secretary of HHS and the Congress tried to account for these cost reductions by holding the annual update factors below the estimated increases in the prices of goods and services hospitals purchase. Despite these attempts, aggregate payments are expected to exceed aggregate costs by 11.5 percent in fiscal year 1987. Proponents contend, therefore, that lower and rebased payments would reflect more recent costs and technologies for providing care in a rapidly changing industry. For example, some services formerly provided during an inpatient stay, and hence included in 1981 costs, are now provided in outpatient settings or skilled nursing facilities where they are separately reimbursed on a reasonable-cost basis. Therefore, the lower rebased rates would avoid what is, in effect, double payment for these services.

Opponents argue that some or all of the current surplus should be left in a rebased system. The hospital industry believes it should be able to retain at least some of this surplus since the ability to profit, along with the risk of costs exceeding payments, was an integral part of the financial incentives provided by the system. In addition, some analysts point out that inadequacies in the PPS rates--for example, the way they account for severity of illness and wage differences among areas--adversely affect particular hospitals in an unfair and unintended manner. Therefore, they maintain that some of the aggregate surplus should be retained as a cushion until the PPS system can be improved, because only by paying more to all hospitals could the unfairly affected ones be helped. If, for example, three percentage points were left in the system--that is, if the urban rates were reduced by 7.7 percent and the rural rates by 4.3 percent (for a weighted average of 7.1 percent)--Medicare outlays would fall by $18.9 billion over the 1988-1992 period.

ENT-02 REDUCE MEDICARE'S PAYMENTS FOR THE INDIRECT COSTS OF MEDICAL EDUCATION

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Outlays	370	450	500	550	600	2,470

Medicare's prospective payment system (PPS), which is described in ENT-01, pays higher rates to hospitals with teaching programs to cover their additional costs of Medicare patient care. The federal portion of payments to these hospitals is raised by approximately 8.1 percent for each 0.1 percentage point of the hospital's ratio of full-time equivalent interns and residents to its number of beds. This adjustment was calculated to compensate hospitals both for their indirect teaching costs--such as the greater number of tests and procedures thought to be prescribed by interns and residents--and to cover higher costs caused by a variety of factors that are not otherwise accounted for in setting the PPS rates. These factors include severity of illness within diagnosis-related groups (DRGs), location in inner cities, and a more costly mix of staffing and facilities--all of which are associated with large teaching programs. If payments for the costs of treating a "disproportionate share" of low-income patients (a characteristic also associated with teaching programs) had also been included in the indirect teaching adjustment, it would have been 8.7 percent. The difference (0.6 percentage points), which is not paid as part of the indirect adjustment, is used to finance part of the payments that are now made under a separate adjustment to hospitals for the costs of treating a disproportionate share of low-income patients.

If the indirect teaching adjustment were reestimated using the new cost data for 1984 (which imply an adjustment of 6.9 percent rather than 8.7 percent), and the financing of the disproportionate-share adjustment were also recalculated, then outlays would fall by $2.5 billion over the 1988-1992 period.

Proponents point out that this option would better align payments with the actual costs incurred by teaching institutions, which fell substantially in real terms between 1981 and 1984. On the other hand, this alternative would considerably reduce payments to teaching hospitals, thereby potentially lowering the access and quality of care for some beneficiaries.

While agreeing that the indirect teaching adjustment should be lowered, other individuals argue that the reductions in Medicare's payments should be returned to hospitals in general rather than removed from the PPS system as budget savings. They hold this view because the indirect teaching adjustment was originally financed by lowering payments to all other hospitals rather than by increasing outlays.

The Congress might want to consider recalculating and lowering the basic rates (see ENT-01) and reducing indirect teaching payments simultaneously. In this case, the payment reductions resulting from this last option might either be used to lower Medicare outlays as described above, or they could be returned to all hospitals by allowing PPS rates to be somewhat higher than would result from implementing ENT-01 alone.

ENT-03 REDUCE REIMBURSEMENTS FOR CAPITAL EXPENDITURES UNDER MEDICARE

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Move Immediately to a Prospective Reimbursement System						
Outlays	120	180	220	250	310	1,080
Move Immediately to a Prospective Reimbursement System and Redefine Capital Expenses						
Outlays	290	330	340	390	450	1,800
Move Slowly to a Prospective Reimbursement System and Redefine Capital Expenses						
Outlays	10	45	120	220	360	760

Although the Social Security Amendments of 1983 set up a prospective payment system (PPS) to reimburse hospitals for operating costs associated with treating Medicare beneficiaries in various diagnosis-related groups (DRGs), they did not change the retrospective, cost-based method of reimbursing capital-related expenses such as interest, rent, and depreciation. Under the Omnibus Reconciliation Act of 1986, cost-based reimbursements will be reduced by 3.5 percent in fiscal year 1987, 7.0 percent in 1988, and 10 percent in 1989. Reimbursements for capital expenses account for about 9 percent of Medicare payments to hospitals--roughly $4 billion in fiscal year 1987.

All three of the approaches discussed here would lead to prospective payment for capital-related expenses. The first two would do so immediately, while the third would partially retain cost-based reimbursement during a five-year transition to a fully prospective system. In addition, two of the approaches would redefine the capital expenses that would be eligible for reimbursement under the prospective system. Under all three approaches, the payments would be reduced by an additional 7 percent in 1988 and 10 percent in 1989 to parallel the cuts enacted in 1986.

Move Immediately to a Prospective Reimbursement System. The current cost-based method of reimbursement for capital-related expenses could be replaced immediately by a prospective system under which capital expenses would be reimbursed by increasing the DRG rates to reflect capital costs. If payments for capital were set to their level in 1987 on a per-case basis, Medicare outlays would be reduced by $1.1 billion during the 1988-1992 period. These savings would accrue because the DRG payments are projected to grow more slowly than actual capital costs.

Reimbursing capital expenses by increasing the current DRG rates would have several advantages. First, hospitals would have incentives to reduce their capital costs as well as operating costs--for example, by seeking to delay projects when interest rates were high, whereas now that is not advantageous because all interest costs are reimbursed. In addition, this approach would avoid the current incentive to substitute capital for labor--the incentive that comes from combining prospective reimbursement for operating costs with cost reimbursement for capital expenses--even when that substitution would raise the hospital's total costs. Finally, prospective payments by Medicare would make federal outlays more predictable and controllable--for example, they could be controlled even if a hospital building boom occurred in the coming years.

The major drawback to this approach is that the capital expenditures of individual hospitals tend to be large and to occur infrequently. As a result, some hospitals have capital expenses that are much higher than average in some years and much lower in other years. In other words, an add-on based on the average level of capital costs per case in a base year would generally not match any particular hospital's current expenses.

A way to avoid large windfall gains and losses for some hospitals would be to have a transition period during which part of the prospective payment would be based on the increase or add-on described above and part would be based on the particular hospital's capital costs per case in the base year. This modification--which is similar to the transition method used under the PPS system for operating costs--would still move to a prospective system immediately and would not affect the total savings. The distribution of payments among hospitals during the transition period would differ, however. Hospitals that have recently undertaken large capital obligations would gain, relative to using only a national add-on, while hospitals that currently have below-average capital expenses but need to modernize in the near future would lose.

Move Immediately to a Prospective Reimbursement System and Redefine Capital Expenses. In addition to paying for capital prospectively, as in the

previous option, the definition of capital expenses used to calculate the add-on could be changed in two ways. First, Medicare could exclude the proportion of capital costs related to return-on-equity (ROE), which is currently an allowable cost only for proprietary hospitals. Under the provisions of the Consolidated Budget Reduction Act of 1986, payments for ROE will be reduced by 25 percent in fiscal year 1987, 50 percent in 1988, and 75 percent in 1989. Thereafter, Medicare will not reimburse for ROE. Under this option, the Congress would end payments for ROE in 1987.

Proponents argue that the federal government ought to reimburse all hospitals in the same way--whether they are voluntary or proprietary. Moreover, because proprietary hospitals receive only about 10 percent of Medicare's payments, they point out that including ROE in the base for calculating the average capital cost per case would spread these payments across all hospitals, effectively generating windfall gains for the voluntary ones. But other analysts contend exactly the opposite--that ROE is a legitimate cost of doing business and either should continue to be reimbursed based on actual costs or should be paid prospectively under a separate add-on that would apply only to proprietary hospitals.

A second definitional change would reduce the amount of interest expenses used to calculate the add-on by the amount of interest hospitals earn on funded depreciation. Advocates of this offset point out that hospitals have invested their funded depreciation to generate income rather than using it to reduce the level of their outstanding debt. Moreover, they argue that the federal government should not reward hospitals for the resulting increase in their interest expenses. Opponents contend, on the other hand, that the prospective payments for operating costs have not kept up with inflation and that further cuts in federal payments would add to the financial stress some hospitals are experiencing from the PPS.

This option would lower Medicare's outlays by $1.8 billion during the 1988-1992 period. These savings would accrue both because the redefinition would lower the 1987 base amount of capital expenses, and because under the prospective system for capital--which shares the advantages and disadvantages discussed in the previous option--payments are projected to grow more slowly than actual capital costs.

Move Slowly to a Prospective Reimbursement System and Redefine Capital Expenses. Another approach would be to move gradually from the current cost-based system to a prospective one in which capital expenses were redefined. For example, if during a five-year transition period, 95 percent, 80 percent, 60 percent, 40 percent, and 20 percent, respectively, of the

reimbursement were based on capital costs as now defined, with the remainder based on the prospective system described in the second option, cumulative savings for fiscal years 1988 through 1992 would be $760 million.

Advocates of this approach argue that continuing partial cost-based reimbursement during a transition period would lessen financial stress for two large groups of hospitals--those with current high capital costs and those planning large capital investments during the transition period. It also would reduce windfall gains for many others whose actual costs would be below Medicare's payments under either of the first two options. Opponents counter that this approach would substantially reduce budgetary savings compared with immediate implementation of a prospective system and that the positive incentives of paying prospectively would be delayed.

ENT-04 REDUCE TOTAL MEDICARE DIRECT MEDICAL EDUCATION PAYMENTS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Outlays	150	160	170	170	180	830

Medicare's prospective payment system does not include payments to hospitals for their direct costs of graduate medical education (GME)--that is, residents' and teachers' salaries, administrative costs, classroom expenses, and the associated hospital overhead costs. Instead, these payments are made separately, but also prospectively, based on Medicare's share of the hospital's historical cost per resident. Medicare's GME payments, which are received by about one in six hospitals, represent approximately 2 percent of Medicare's payments for inpatient care, but cover nearly one-third of hospitals' total GME costs..

Several arguments support reducing Medicare's payments for GME. Many observers argue that such subsidies are unwarranted since the United States is facing a projected aggregate surplus of physicians. Moreover, since physicians earn much higher incomes as a result of their GME, they might reasonably contribute more to these costs themselves.

If the Congress were to reduce Medicare's total GME payments by 15 percent, the five-year savings would be about $830 million. (This option would not change training programs for nursing and allied health professions.) This reduction could be accomplished in several ways: reduce the per-resident payment for every hospital by 15 percent; cap each hospital's per-resident payment at the median; or eliminate per-resident payments to hospitals for graduates of foreign medical schools (FMGs).

Among those groups who believe Medicare's GME payments should be reduced, advocates of a uniform 15 percent reduction in per-resident payments support it mainly on grounds of fairness. Advocates of a cap suggest that only constraining payments to hospitals with historically high per-resident costs would generally penalize the most inefficient hospitals. Advocates of eliminating payments to FMGs favor discouraging their employment because of concerns about their quality as well as their contribution to projected surpluses of physicians.

Reducing Medicare's GME payments could have several drawbacks, however. Many hospitals have built their training programs based on expectations of Medicare's reimbursements for GME. Decreasing or eliminating Medicare's GME payments could force some programs to reduce the resources they commit to training, or even to close. This response could, in turn, reduce access to health-care services in some communities.

ENT-05 ADOPT A FEE SCHEDULE FOR REIMBURSING PHYSICIANS UNDER MEDICARE

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Fee Schedule with Rates Updated Annually by the MEI						
Outlays	90	340	500	660	820	2,410
Fee Schedule with Spending Cap Set by the MEI						
Outlays	560	2,140	3,680	5,410	7,380	19,170
Fee Schedule with Spending Cap Set by Growth in GNP						
Outlays	200	770	1,250	1,880	2,670	6,770

Medicare currently reimburses physicians under the Supplementary Medical Insurance (SMI) program for "reasonable" charges for all covered services. A reasonable charge for a given service is the lowest of the physician's actual charge, the physician's customary charge for that service, or the prevailing charge for that service in the local community. This practice is known as the customary, prevailing, and reasonable (CPR) system.

Because of the automatic and inflationary link between physicians' actual charges and Medicare's payment rates in the next year, the CPR system has been criticized for contributing unnecessarily to cost increases. To weaken this link, since 1973, the allowed rate of increase in prevailing fees has been limited to the rate of increase in an economywide index of office expenses and earnings--the Medicare Economic Index (MEI). Because only about half of all physicians' charges are at the ceiling set by MEI-adjusted prevailing fees, however, the rate of increase in payment rates has exceeded increases in the MEI.

Rates Updated by the MEI. One alternative to the CPR system would be to implement a Medicare fee schedule for physicians' and related services--with adjustment for local differences in costs. A fee schedule could perhaps be put in place by January 1, 1988. The fee schedule that would be

effective during 1988 could be set at the average amounts allowed for each service during 1987, with increases in payment rates for 1988 and each year thereafter determined by the rate of increase in the MEI. Savings under this option would be $90 million for fiscal year 1988. Savings would total $2.4 billion over the 1988-1992 period, reducing net SMI outlays by about 1.4 percent.

A fee schedule based on average allowed amounts would incorporate elements of the current fee structure that many people believe need to be corrected. For example, current amounts may include excessive payments for certain procedures that are either ineffective or far less costly to perform now than when they were first introduced. The rate structure could be modified incrementally after it has been put in place, or changes in physician payment methods could be delayed for a year or two until a more appropriate fee structure was developed. (The Health Care Financing Administration has awarded a contract to develop a relative value scale that could serve as the basis for a fee schedule; completion is scheduled for mid-1988.) Control of total costs in a fee-for-service payment system probably requires constraints on the volume the of services as well as on fees, however. Without volume controls, some physicians might respond to constraints on fees by providing additional reimbursable--but unnecessary or only marginally useful--services.

Cap Set by the MEI. Other countries have successfully contained increases in volume under fee-for-service systems by using a combination of two mechanisms: volume-related adjustments in payment rates to cap total spending for physicians' services, together with a systematic monitoring of the practice profiles of physicians to prevent individual ones from making above-average increases in their billings at the expense of other physicians. If increases in the average approved charges per enrollee were limited by increases in the MEI--so that payment rates would be reduced to offset increases in the average volume per enrollee--savings under the fee schedule discussed above would increase to $560 million for 1988 and would total $19.2 billion over the five-year period. Some increases in the average volume of services per enrollee might be desirable, however, to account for aging of the Medicare population and medical advances.

Cap Set by Growth in GNP. Average charges per enrollee could be permitted to increase by the growth in physicians' practice costs plus an appropriate allowance for aging and technology, before triggering a downward adjustment in payment rates. The appropriate allowances for these factors could be difficult to determine, however. To do so would be especially difficult for medical advances, which might either increase or reduce the variety and costs of services that could benefit enrollees.

One option would be to allow total charges per enrollee to increase each year according to growth in GNP. Consequently, some increase in the volume of services per enrollee would be permitted so long as payment rates increased less rapidly than GNP. Savings under this option would be $200 million for 1988 and $6.8 billion over the five-year projection period, but the allowed growth in volume could be greater or less than that warranted by aging and technological change.

Other Approaches. Alternate methods could reduce the undesirable incentives for volume by basing reimbursements on more comprehensive packages of services--such as all services required by enrollees during a specified period of time (capitation). Before this kind of alternative could become the dominant payment method for physicians' services under Medicare, however, a number of issues about implementation and feasibility would need to be resolved. Implementation of a fee schedule now would not prevent more fundamental changes in payment methods later, when acceptable alternative approaches are developed.

ENT-06 INCLUDE HOSPITAL-BASED PHYSICIANS' SERVICES IN HOSPITALS' PROSPECTIVE PAYMENTS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Outlays	70	170	240	310	400	1,190

Radiologists, anesthesiologists, and pathologists (RAPs) are supporting physicians who typically have contractual arrangements with hospitals that grant them exclusive rights to provide services to hospitals and their inpatients. These contractual arrangements typically cover payment provisions for certain administrative services provided to the hospitals by RAPs, but not for their patient-related services. Instead, RAPs bill patients (or their insurers) directly, on a fee-for-service basis. Because hospitals select the RAPs who will provide services to their inpatients, however, hospitals are in a better position than patients to negotiate with these hospital-based physicians.

Medicare could eliminate fee-for-service reimbursement for the inpatient services provided by RAPs. Instead, the hospitals' DRG payments under Part A of Medicare could be expanded to reflect the costs of all services provided by RAPs to hospital inpatients, with payments to RAPs constrained to grow at the same rate as DRG payments in future years. If this change was implemented beginning January 1, 1988, with each DRG rate for 1987 first increased by the average cost to Medicare in 1987 for services provided by RAPs to patients in that DRG and then updated by an appropriate price index, savings would be $70 million in fiscal year 1988. Savings would total about $1.2 billion over the five-year projection period, reducing Medicare's net outlays for physicians' services by about 0.7 percent. These estimates assume that shifting costs to the outpatient sector would be prevented for the most part by, for example, denying payment for related RAP services provided within seven days on either side of an inpatient stay.

This option would give hospitals incentives they now lack to negotiate reasonable rates of pay for RAPs and to use their services efficiently. As a result, payments for the services provided by RAPs would be lower under this payment method than under the current system, thus reducing both

Medicare's and patients' costs. In fact, coinsurance and balance-billing amounts for which patients are currently liable under Part B of Medicare would be eliminated on inpatient services provided by RAPs. Consequently, out-of-pocket costs for patients would drop by a much higher percentage than Medicare's costs.

Either RAPs or hospitals, however, would be worse off under this option. Total payments to RAPs for services to Medicare inpatients would fall, unless hospitals accepted the loss by paying RAPs more, on average, than the amount by which DRG rates were increased. The allocation of this reduction in receipts between RAPs and hospitals would vary by locality, depending on the extent of competition for the services of RAPs. The reduction in Medicare receipts that would occur under this option might adversely affect access for Medicare enrollees in some isolated areas. But this effect would not be widespread because RAPs are among the most highly paid physician specialties, and because most hospitals have fared well under the prospective payment system.

ENT-07 INCREASE MEDICARE'S PREMIUM FOR PHYSICIANS' SERVICES

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Outlays	1,180	2,210	3,080	4,060	5,180	15,710

Medicare's Supplementary Medical Insurance (SMI) program is partially funded by monthly premiums--currently $17.90--paid by enrollees. Between 1972 and 1982, premium receipts covered a declining share of SMI costs--dropping from 50 percent to 25 percent--because premiums were tied to the rate of growth in Social Security benefits, which is based on the Consumer Price Index, rather than on the faster-rising per capita cost of SMI. (The remaining costs are paid from general revenues.)

In 1982, premiums were set through 1985 (later extended through 1988) to cover 25 percent of the average benefits for an aged enrollee. Under current law, beginning in 1989 the premium calculation will again be limited to the rate of growth of Social Security benefits. If, instead, the premium were set so that enrollees would pay 30 percent of benefits beginning January 1, 1988, and for all years thereafter, federal savings would total $1.2 billion in fiscal year 1988 and $15.7 billion over the five-year period. The estimated premium would be $26.10 on January 1, 1988, instead of the scheduled $21.70. Net outlays for SMI would be reduced by about 9 percent over the five-year period.

Under this option, the increase in payments would be shared by all enrollees, in contrast to proposals--such as increasing copayments--that would affect only the users of medical services, who may be financially pressed during their period of illness. Also, this option would not affect the poorest enrollees because they are likely to be eligible for Medicaid, which usually pays the SMI premium on their behalf. For those not eligible for Medicaid, the higher premium would be about 5 percent of the average monthly Social Security benefit in 1988, slightly more of a burden than in 1967--the first full year for Medicare--when the premium was 3.6 percent of the average Social Security benefit.

Low-income enrollees who are not eligible for Medicaid, however, could find the increased premium burdensome. A few might drop SMI coverage and either do without care or turn to sources of free or reduced-cost care, which could increase demands on local governments. In addition, the costs for states would increase for Medicaid-eligible Medicare enrollees because states would pay part of the higher premium costs for those enrollees.

ENT-08 USE THE TAX SYSTEM TO IMPOSE A SUPPLEMENTARY INCOME-RELATED PREMIUM FOR PHYSICIANS' SERVICES

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Savings
	1988	1989	1990	1991	1992	
Addition to CBO Baseline	0.6	2.0	2.2	2.4	2.6	9.8

Part B of Medicare offers Supplementary Medical Insurance (SMI), which covers a portion of enrollees' physician and other nonhospital charges. Participation is voluntary, and enrollees currently pay a monthly premium of $17.90. The premium is adjusted annually (through 1988) to cover 25 percent of the average benefits received by elderly enrollees. The balance of costs, more than $25 billion for 1988, is paid from general revenues.

An alternative to increasing the share of costs financed by the premium would be to impose a supplementary income-related premium that would be paid by all SMI enrollees. To avoid having to set up a new bureaucracy to collect these premiums from enrollees, this option could be most conveniently introduced through the income tax system. This approach would exempt from the tax those individuals who chose not to enroll in the SMI program.

A 1 percent tax, for example, could be imposed on enrollees' taxable income. A ceiling on added tax liability for each tax filing unit (usually an elderly individual or couple) could be set by the number of SMI enrollees in the unit times the average value of subsidized SMI benefits per enrollee. In this way, no unit would pay more than the full actuarial value of its benefits. If an SMI tax of 1 percent were imposed on taxable income for all units with at least one SMI enrollee during the tax year (prorated for part-year enrollment), revenues earmarked for the SMI trust fund would be increased by $0.6 billion in 1988, and by $9.8 billion over the 1988-1992 period. Five-year revenues would equal about 6 percent of SMI net outlays.

In contrast to the premium discussed in ENT-07, this approach would fall less heavily on low-income enrollees and more heavily on those with high incomes. The poorest enrollees--those with no taxable income--would

not be affected, whether or not they were eligible for Medicaid benefits. The amount paid would vary directly with the amount of taxable income. As a result, individuals with taxable income below $5,280 a year would pay less under this approach, while those with taxable income above $5,280 would pay more than if premiums were increased to cover 30 percent of costs. The effect on low- and moderate-income enrollees could be reduced still further by using personal income tax rates--as in ENT-09--rather than the proportional tax used in this option.

Some people might consider this tax inequitable because the amount of tax paid by each tax unit would not vary with the number of SMI enrollees in a unit, except for a small number of high-income tax units affected by the ceiling. In addition, some might question whether it was fair to require those with higher incomes to pay a relatively greater share of SMI costs when such people are typically less costly to the Medicare program because of their better health.

ENT-09 TAX A PORTION OF MEDICARE BENEFITS

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Addition
With Income Threshold	0.7	2.5	3.0	3.6	4.2	14.0
Without Income Threshold	1.4	5.0	5.6	6.4	7.2	25.6

Eligibility for Hospital Insurance (HI) benefits is based on working-year tax contributions, half of which are paid by employees from after-tax income and half by employers from pre-tax income. Eligibility for Supplementary Medical Insurance (SMI) depends on payment of a premium, which currently covers about 25 percent of SMI benefits. Hence, effective January 1, 1988, 50 percent of the insurance value of HI benefits and 75 percent of the insurance value of SMI benefits might be treated as taxable income for enrollees. (The resulting tax proceeds could be returned to the Medicare trust funds.) This proposal is analogous to taxing part of Social Security benefits, which is already part of the law for beneficiaries for whom modified adjusted gross income plus half of Social Security benefits exceeds $25,000 (for individuals) or $32,000 (for couples) (see REV-18).

If the current income thresholds for the tax on Social Security benefits were also used to limit the application of the tax on Medicare benefits--with the portion of Medicare benefits described above added to modified adjusted gross income plus half of Social Security benefits to compare with the threshold--then taxing both HI and SMI benefits would yield additional revenues of $0.7 billion in 1988 and $14 billion over the 1988-1992 period. If no income thresholds were used to limit the application of the Medicare tax, additional revenues would be $1.4 billion in 1988 and $25.6 billion over the five-year period.

A tax on HI benefits would strengthen the HI trust fund. A tax on SMI benefits would shift some SMI costs from the general taxpayer to enrollees, without increasing costs for low-income enrollees and therefore not threatening their access to care. Moreover, if income thresholds were used, even middle-income enrollees would be protected from additional liability

under this option. In contrast to ENT-08, people enrolled in the SMI program would never pay the full insurance value of their benefits under this option, since the maximum personal income tax rate to be applied to the subsidy value of benefits would be 33 percent under current law. Further, since this option would use the mechanism already in place for taxing Social Security benefits, it would present no additional administrative difficulty.

Unlike the tax on Social Security benefits, though, this tax would be imposed on the insurance value of in-kind benefits rather than on dollar benefits actually received--a modification of current tax policy. (If the tax were imposed on actual benefits received, however, the Medicare tax would be directly related to enrollees' health-care costs, reducing the insurance protection Medicare is intended to provide.) In addition, some people might object to this option because enrollees could not alter their tax liability by choosing a different package of benefits, except by dropping SMI or all Medicare coverage. Further, because of their better health, people with higher incomes are typically less costly to the Medicare program. Thus, requiring them to pay a greater share of the costs might be viewed as inequitable. Finally, the additional tax liability could be substantial for some enrollees--nearly $500 in 1988 for those in the 28 percent tax bracket, although most Medicare enrollees would be in a lower tax bracket or unaffected by the proposal.

ENT-10 INCREASE MEDICARE'S DEDUCTIBLE FOR PHYSICIAN SERVICES

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Outlays	1,000	1,670	1,930	2,120	2,320	9,040

Appreciable federal savings in Medicare's Supplementary Medical Insurance (SMI) program could be realized by increasing the deductible--that is, the amount that enrollees must pay for services each year before the government shares responsibility. The deductible is now $75 a year. This deductible has been increased only twice since Medicare began in 1966, when it was set at $50. Hence, the deductible has fallen relative to average per capita benefits from 70 percent in 1967 to less than 8 percent for 1987. Increasing the SMI deductible to $200 on January 1, 1988, and indexing it thereafter to the rate of growth in the Consumer Price Index would save $1 billion in fiscal year 1988. Savings would total $9 billion over the five-year period from 1988 through 1992, reducing SMI outlays by about 5 percent.

Such an increase would spread the burden of reduced federal outlays among most enrollees, raising their out-of-pocket costs by no more than $125 each in 1988 (which would be partially offset by reduced premium costs of $1.10 a month). Since a larger proportion of enrollees would not exceed the deductible (currently about 30 percent do not), it would both increase the number of enrollees with strong incentives for prudent consumption of medical care and reduce administrative costs to process claims.

On the other hand, even relatively small increases in out-of-pocket costs could prove burdensome to low-income enrollees who do not receive Medicaid, which pays deductible amounts for dual Medicaid-Medicare beneficiaries. That added expense might, in turn, discourage some people from seeking needed care.

ENT-11 CAP EACH ENROLLEE'S COPAYMENT LIABILITY UNDER MEDICARE AND IMPOSE A TAX ON "MEDIGAP" POLICIES

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Outlays	860	2,700	3,760	4,140	4,350	15,810

As a result of Medicare's cost-sharing requirements and limitations of coverage, enrollees who require many services during the year can incur substantial costs. The potential for high out-of-pocket costs--that is, cost-sharing other than premiums--induces about 70 percent of aged Medicare enrollees to purchase supplementary private insurance ("medigap" policies) to cover those costs. For those with supplementary coverage, use of services is higher than it would otherwise be because cost-sharing is eliminated. This effect increases not only medigap benefit payments, but also raises Medicare's costs. For those who lack supplementary coverage, out-of-pocket costs may sometimes be prohibitive, with the result that some enrollees may be unable to obtain needed health-care services.

Medicare could cap each enrollee's annual copayment liability and finance this new benefit by imposing a tax on benefits paid by medigap policies (which would probably cause insurers to raise medigap premiums). If each enrollee's liability for copayments under Medicare were capped at $2,000 in 1988, with the cap increased each year thereafter by the Consumer Price Index, Medicare costs would increase by $1.7 billion in 1988. If taxes equal to 80 percent of benefits paid by medigap policies were collected from medigap insurers, the revenues collected would total $2.6 billion in 1988. Net federal savings in fiscal year 1988 would be $0.9 billion. Cumulative savings over the five-year projection period would be $15.8 billion, reducing net outlays for Medicare by about 3 percent. (The medigap tax revenues are treated as negative outlays here.)

The copayment cap would protect most enrollees against catastrophic out-of-pocket costs for acute health-care needs--protection that those without supplementary coverage do not have at present. A medigap tax of 80 percent would be just sufficient to recover the extra federal costs that arise because medigap policyholders use more Medicare-covered services than

those without supplementary coverage. Federal savings from the medigap tax would stem either from tax receipts on policies that enrollees continued to purchase despite their higher cost, or from lower use of health-care services by those who would drop medigap coverage in response to improved Medicare coverage and higher medigap premiums.

Some private insurers might object to this approach, though, because Medicare enrollees would probably purchase fewer medigap policies. In addition, copayment costs could still be prohibitive for some low-income enrollees because the cap would not be income-related (a modification that would be difficult to administer).

Except for the cap, this proposal would leave the current structure of copayments unchanged, although many people think that it is inappropriately designed. The proposal could, however, easily be modified to include any new copayment requirements as well as the copayment cap. For example, cost-sharing could be introduced to curtail overuse of services where patients can exercise considerable discretion (such as home health services). At the same time, cost-sharing could be eliminated for services--such as extended hospital stays--where use is largely beyond the patient's control.

A related proposal to set limits on copayments under Medicare was recently introduced by the Secretary of the Department of Health and Human Services. Under that plan, the new Medicare benefits would be financed by an additional premium paid by all enrollees.

ENT-12 LIMIT FEDERAL PAYMENTS FOR LONG-TERM CARE

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Reduce Federal Medicaid Matching Rate						
Budget Authority	790	870	950	1,040	1,130	4,780
Outlays	790	870	950	1,040	1,130	4,780
Limit Federal Medicaid Increases to the Medical CPI Rate						
Budget Authority	860	930	1,020	1,100	1,190	5,100
Outlays	860	930	1,020	1,100	1,190	5,100
Establish a Comprehensive Block Grant						
Budget Authority	1,350	2,900	4,400	6,000	7,650	22,350
Outlays	1,350	2,900	4,400	6,000	7,650	22,350

In the last several years, federal spending for long-term care has grown rapidly, often exceeding the growth in outlays for several other types of health care. For example, between 1980 and 1985, federal Medicaid payments for hospital care grew by an average annual rate of 8 percent, while payments for nursing home and home health services grew at an 11 percent rate. Medicaid spending for nursing home care, which made up 45 percent of Medicaid's outlays in 1985, constitutes the bulk of federal costs for long-term care.

Growth in federal outlays for long-term care (LTC) could be controlled in several ways, including: (1) retaining the open-ended funding, but lowering the average federal matching rate for Medicaid LTC services--by 3 percentage points, for example; (2) limiting the increase in federal Medicaid payments for LTC to each state to the inflation rate for medical services; or (3) combining all payments to states for LTC services into a block grant that would remain constant in nominal terms over the next five years. The first two options would each save about $5 billion in federal outlays over the 1988-1992 period, while the block grant would save $22 billion over the same time period.

Under the first option, there are many ways in which federal Medicaid matching rates could be reduced so that the average federal matching rate would fall by the desired amount. The impact on each state would depend on the exact formula used. Advocates believe that lowering matching rates would encourage states to operate their long-term care programs more efficiently, economizing on every dollar spent for long-term care. For example, states might replace costly institutional care with less expensive home- and community-based care for more beneficiaries. In addition, the open-ended feature of this option would enable those states experiencing growing needs for LTC--because of their growing elderly populations, for example--to respond with federal assistance, albeit at lower matching rates.

The second approach would limit each state's federal matching payment, while maintaining the current matching rates for spending up to the cap. (The Administration's proposal would apply such a limit to all Medicaid payments.) The cap would increase each year by the change in the medical care component of the Consumer Price Index. Advocates of this strategy prefer it to the first option because it would penalize only those states with the fastest growth in outlays. Also, it would make federal outlays more predictable than they would be under an open-ended matching arrangement.

Alternatively, a comprehensive block grant could be formed by combining federal payments for LTC into a single program that would replace LTC funding in the Social Services Block Grant, Title III of the Older Americans Act, and Medicaid. (LTC services provided by the Medicare program would not be affected by this approach.) Proponents say that comprehensive grants would significantly reduce the amount of fragmentation in the current system that often produces gaps and overlaps in services, and would lower administrative costs. Furthermore, such a plan would cause decisions to be made at the local level where, proponents argue, services could be tailored to local conditions and, therefore, provided more efficiently.

While all three strategies would reduce federal expenditures for long-term care, they would shift more responsibility to state and local governments. Also, the options would reduce the number of people receiving LTC unless states and localities were able to make up for losses in federal funds by greater efficiency or higher contributions. Critics suggest that capping federal Medicaid payments or forming a block grant would make the effective cost that states face of providing LTC so much higher over time that they would reduce services for the near poor. In addition, the same two options would penalize some states that have been best able to contain their LTC costs. Some critics also object to all three strategies because they separate funding for acute-care services from LTC funding. They believe such options would increase competition between the elderly and the non-elderly poor for scarce federal resources.

ENT-13 TAX EMPLOYER-PAID HEALTH INSURANCE

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Addition
Tax Some Employer-Paid Health Insurance						
Income Tax	2.0	3.7	4.5	5.5	6.5	22.2
Payroll Tax	1.2	2.0	2.4	3.0	3.5	12.1
Total	3.2	5.7	6.9	8.5	10.0	34.3
Tax Employer-Paid Health Insurance But Allow a Credit for Some Employer and Employee Contributions						
Income Tax	9.2	3.2	3.9	5.0	6.3	27.6
Payroll Tax a/	9.5	15.0	17.0	18.8	20.7	81.0
Total	18.7	18.2	20.9	23.8	27.0	108.6

a. The budget effects shown here for the payroll tax include the minor reductions in income tax revenues that would result from counting employer-paid health insurance as part of taxable wages under the payroll tax.

Employees do not pay taxes on income received in the form of employer-paid health care coverage. This exclusion will reduce 1989 income tax revenues and Social Security payroll tax revenues by a total of about $34 billion.

Tax Some Employer-Paid Health Insurance. One proposal to limit the exclusion would be to treat as taxable income any employer contributions (including those in cafeteria plans and flexible spending accounts) that exceed $200 a month for family coverage and $80 a month for individual coverage (in 1988 dollars), with these amounts indexed to reflect future increases in the general level of prices. This proposal would raise income tax revenues and payroll tax revenues by a total of $34.3 billion over the 1988-1992 period. Including employer-paid health care coverage in the Social Security wage base, however, would lead to increased outlays on benefit payments that would offset most of the added payroll tax revenues from this option over the long run.

Proponents of this approach point out that it would eliminate the tax incentive to purchase additional coverage beyond the ceiling. In the absence of such coverage, there would be stronger incentives to economize in the medical marketplace and reduced upward pressure on medical care prices. Over the long run, indexing the ceilings would limit their erosion by inflation. Finally, proponents note that the Congress has already limited the exclusion for employer-paid group life insurance (see REV-19).

Opponents object to limiting the tax subsidy, pointing to the difficulty of determining just when extensive coverage becomes excessive. They further argue that a uniform ceiling would have uneven effects, since a given employer's contribution purchases different levels of coverage depending on such factors as geographic location and the demographic characteristics of the firm's workforce. Finally, the indexing provision of this proposal would lead to declining subsidies for employer-paid health insurance over time, if health insurance costs continue to rise faster than the general level of prices. This effect is of concern to people who argue that these subsidies to private-sector benefits help avoid the need for public provision of the same benefits.

Tax Employer-Paid Health Insurance But Allow a Credit for Employer and Employee Contributions. Another option would be to treat all employer-paid health insurance premiums as taxable but offer a tax credit of 20 percent for health insurance premiums up to the amounts described above for family and individual coverage. The credits would be available to taxpayers regardless of whether the coverage was paid for or sponsored by an employer. At this credit percentage and with these premium ceilings, the proposal would increase income tax revenues and payroll tax revenues by a total of $108.6 billion over the 1988-1992 period. As under the first option, however, increases in Social Security outlays would offset most of the added payroll tax revenues in the long run.

Proponents of this approach argue that, in addition to eliminating the tax incentive to purchase health insurance above the limits, the subsidy would be made available to taxpayers without regard to their employment status. Moreover, the subsidy per dollar of eligible health insurance coverage purchased would not be higher for taxpayers with higher incomes. Others, however, object that this proposal does not go far enough, because the benefits of a tax credit would not be available to low-income individuals and families who have no liability under the federal personal income tax, unless the credit were made refundable. To do so would substantially reduce the net revenues discussed above, however.

As with the first option, some opponents argue that current health insurance coverage is not excessive. Others contend that the tax system should not be used to encourage purchases of certain goods or services and that extending the credit to those who currently have no employer-paid health insurance would do so.

ENT-14 RESTRICT COST-OF-LIVING ADJUSTMENTS IN NON-MEANS-TESTED BENEFIT PROGRAMS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Eliminate COLAs for One Year						
Social Security/ Railroad Retirement	6,550	9,000	9,050	9,050	8,850	42,500
Other Non-Means-Tested Programs	1,700	2,300	2,400	2,450	2,550	11,450
Offsets in Means-Tested Programs and Medicare Premiums	-1,150	-1,900	-2,050	-2,200	-2,300	-9,600
Total	7,150	9,400	9,400	9,300	9,100	44,350
Limit COLAs to Two-Thirds of CPI Increase for Five Years						
Social Security/ Railroad Retirement	2,250	5,400	9,000	12,600	16,250	45,450
Other Non-Means-Tested Programs	580	1,400	2,300	3,250	4,300	11,850
Offsets in Means-Tested Programs and Medicare Premiums	-70	-240	-430	-670	-910	-2,300
Total	2,750	6,600	10,850	15,200	19,600	55,000
Limit COLAs to CPI Increase Minus Two Percentage Points for Five Years						
Social Security/ Railroad Retirement	3,200	7,750	12,500	17,500	22,650	63,550
Other Non-Means-Tested Programs	830	2,000	3,200	4,550	5,950	16,550
Offsets in Means-Tested Programs and Medicare Premiums	-100	-340	-610	-940	-1,250	-3,250
Total	3,950	9,350	15,100	21,100	27,300	76,850
Pay Full COLA on Benefits Below a Certain Level and 50% of COLA on Amounts Exceeding That Level						
Social Security/ Railroad Retirement	710	1,750	2,900	4,050	5,250	14,650

Social Security and other non-means-tested cash transfer programs whose benefits are indexed to the Consumer Price Index (CPI) are expected to total $268 billion this year and to rise to $366 billion by 1992 under current policies. Reducing the automatic cost-of-living adjustment (COLA) for these programs is commonly proposed as an effective way to slow the growth in entitlement spending. Four strategies for reducing COLAs and the savings in outlays resulting from each are shown in the table. 1/ Other options for achieving savings in Social Security are given in ENT-15 and ENT-16.

Advocates of COLA restrictions view them as a means of generating considerable savings by spreading the burden over a large number of beneficiaries, in contrast to other budget options that would concentrate benefit reductions on smaller groups of recipients. By limiting these options to the non-means-tested cash benefit programs, many of the poorest beneficiaries of entitlements--for example, recipients of Supplemental Security Income--would be protected from losses of income. Significant reductions in outlays would persist beyond the five-year projection period because the benefit levels of those eligible when the COLA limitation was implemented would be permanently lowered. The savings would eventually disappear as beneficiaries died or ceased receiving payments for other reasons, unless the COLA limitation was accompanied by a permanent reduction in the initial benefits of newly eligible workers as well (see ENT-15).

Opponents counter that budget reduction strategies that institute less than complete price indexing would result in financial difficulties for many recipients, particularly if they were applied for an extended period. Although the exclusion of means-tested benefit programs would limit the impact of COLA reductions for many low-income beneficiaries, many others would face substantial declines in their standards of living. COLA reductions also encounter opposition from those who fear that changes made to reduce budget deficits would undermine the entire structure of retirement

1. The programs whose COLAs would be reduced under the first three options are: Social Security Old-Age, Survivors, and Disability Insurance (OASDI), Railroad Retirement, Civil Service Retirement, Military Retirement, Federal Employees Workers' Compensation, Veterans' Compensation, and retirement benefits for the Foreign Service, the Public Health Service, and the Coast Guard. The fourth option would affect only Social Security and Railroad Retirement Tier I COLAs. Curtailing COLAs could cause some beneficiaries' means-tested benefits to increase and could limit some scheduled premium increases for the Supplementary Medical Insurance part of Medicare, as shown in the table. Reductions in income tax revenues associated with COLA restrictions are not included.

income policy. Private pension plans generally do not offer complete indexing; COLA restrictions in Social Security would make it more difficult for beneficiaries to protect themselves against inflation. Opponents argue that these programs should be altered only gradually and then only for programmatic reasons, because Social Security and other retirement programs represent long-term commitments both to current retirees and to today's workers. Thus, any changes in benefits should be announced well in advance to allow people to adjust their long-run plans.

If COLA limitations were adopted to restrict the growth in benefits for people after they retire, commensurate changes could be made in determining initial benefits for new recipients to avoid introducing disparities in benefit levels among different groups of retirees. This situation is particularly relevant for Social Security, where benefits for those individuals becoming eligible are based on an indexed benefit formula and on indexed earnings histories. For example, if prices rose by 4 percent in a year and the wage index used to compute benefits for newly eligible recipients increased by 5 percent, eliminating that year's COLA without any change in the calculation of initial benefits would result in benefits for new beneficiaries that were about 5 percent higher than for recent retirees; under current law, benefits would be only about 1 percent higher for the new retirees. To mitigate this problem and to achieve additional savings, efforts to slow the growth in benefits through COLA limitations might be extended to the formulas determining initial benefits (see ENT-15).

Several options that would restrict COLAs for current beneficiaries are examined below. The magnitude of the savings in each case--except the option to limit COLAs to two percentage points less than the CPI--is very sensitive to the assumed level of inflation in the years in which the COLAs would be reduced.

Eliminate COLAs for One Year. One option would be to eliminate COLAs in fiscal year 1988 for non-means-tested benefit programs, while allowing them to be paid in subsequent years but with no provision for making up the lost adjustment. If this approach were taken, federal outlays would be reduced by about $7.1 billion in 1988 and $44.3 billion over five years, with Social Security and Railroad Retirement accounting for most of the total. These estimated reductions would be larger or smaller if prices were to rise faster or slower than the 4.1 percent increase currently assumed for the fiscal year 1988 COLA.

Limit COLAs to Two-Thirds of CPI Increase. Under this option, recipients would be compensated for only a certain proportion of inflation, such as

two-thirds of the annual CPI increase. Under current CBO economic assumptions, applying this restriction for five years would save about $2.8 billion next year and $55 billion over the 1988-1992 period. As a result, benefits for people who received payments throughout the five-year period would be about 7 percent less in 1992 than they would have been under full price indexing. Both cumulative savings and reductions in real income would be greater in an environment of higher inflation and smaller under low inflation.

Index Benefits by the CPI Increase Minus Two Percentage Points. An approach similar to the proportionate COLA reduction would be to reduce the adjustment by a fixed number of percentage points--for example, set the adjustment at the CPI increase less two points. In this case, both savings and effects on beneficiaries would be roughly the same regardless of the level of inflation--about $76.8 billion over the next five years, if extended for the full period. This option would reduce real incomes by about the same percentage every year, regardless of the inflation rate, whereas the two-thirds-of-COLA approach would reduce the purchasing power of benefits most sharply when inflation is high during the five-year period.

Pay the Full COLA on the Portion of Benefits Below a Certain Level and 50 Percent of the COLA on Benefits Exceeding That Level. To ensure that lower-income beneficiaries would not be adversely affected by COLA reductions, some analysts have suggested tying the reduction to beneficiaries' incomes or payment levels. The example discussed here--based only on Social Security and Railroad Retirement Tier I benefits--would award the full COLA for benefits based on the first $400 of a retiree's Primary Insurance Amount (PIA) and 50 percent of the COLA on benefits above this level; the $400 threshold would also be indexed by the full COLA. This approach would save about $0.7 billion in 1988 and $14.7 billion over the 1988-1992 period. (Another option would be to eliminate COLAs to recipients whose benefits are based on PIAs above a certain level. This COLA reduction would affect the entire benefit of each recipient above the threshold, not just the portion above that level.)

Several concerns are raised regarding this approach. First, benefit levels are not always good indicators of total income. Some families with high benefits have very little other income, while some with low benefits have substantial income from other sources. On the other hand, targeting the COLA restraint on the basis of total income would be administratively complex. Indeed, implementation of the PIA-based option itself would involve considerable effort and would require a longer lead-time than the other COLA options because the Social Security Administration would need to rewrite many computer programs. (The budgetary savings estimates

shown above nonetheless are based on implementation in time for the January 1988 COLA.) Second, if this proposal were extended to include other benefit programs, the different benefit structure in each program might require separate determinations of the appropriate benefit levels for paying the reduced COLA. Third, many people object to any changes in retirement programs that might be construed as introducing a means test for benefits, even if the "test" is limited only to the COLA.

ENT-15 REDUCE THE REPLACEMENT RATE WITHIN EACH BRACKET OF THE SOCIAL SECURITY BENEFIT FORMULA

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Outlays	80	280	530	850	1,250	3,000

Under current law, the basic Social Security benefit is determined by a progressive formula that provides workers with 90 percent of their Average Indexed Monthly Earnings (AIME) up to the first bend point (which defines the first earnings bracket), plus 32 percent of the AIME in the second bracket, plus 15 percent of the AIME above the second bend point. One method of reducing initial Social Security benefits would be to lower the three replacement rates by a uniform percentage. For example, lowering the three rates in the benefit formula from 90, 32, and 15 to 86.5, 30.8, and 14.4, respectively, would achieve an essentially uniform 3.9 percent reduction in the benefits of newly eligible workers--the same as the reduction in benefits that currently eligible workers would incur by forgoing the projected January 1988 COLA. The reduction in the replacement rates would save about $3.0 billion from Social Security outlays over the 1988-1992 period and more in later years.

Under this option, replacement rates for all newly eligible workers would be about 3.9 percent lower starting in 1988 than they would be under current law. Thus, a 62-year-old retiree who has always earned the average wage would receive initial benefits in 1988 of about 33 percent of pre-retirement earnings, compared with 34 percent if no change is made. This option could be coordinated with a cost-of-living adjustment option (see ENT-14) to ensure that benefits for both current and future beneficiaries would be reduced to a similar extent.

Opponents of cuts in initial benefits contend that it is not necessary to make any permanent reductions beyond those made by the Social Security Amendments of 1983, because the combined assets of the retirement and disability trust funds are expected to be sufficient to pay benefits for at least the next half century. One of the changes made by the 1983 amendments was to increase from 65 to 67 the age at which unreduced Social Security retirement benefits are first available. The change is to be phased in between the years 2000 and 2022. As a consequence, initial benefits for

most workers retiring after the turn of the century are likely to decrease anyway, relative to what they would have received had the full retirement age not been increased. For example, a worker who retires at age 62 in 2022 will receive 70 percent of the Primary Insurance Amount rather than 80 percent.

On the other hand, long-term projections of outlays and revenues should be treated with caution because they are enormously sensitive to the assumptions on which they are based. Reductions in initial benefits or other changes in Social Security benefits or taxes could be enacted as a precautionary measure.

ENT-16 ELIMINATE SOCIAL SECURITY BENEFITS FOR CHILDREN OF RETIREES AGED 62-64

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Outlays	40	180	360	590	650	1,820

Under current law, unmarried children of retired workers are eligible for Social Security dependents' benefits as long as they are under age 18, or attend elementary or secondary schools and are under age 19, or become disabled before age 22. These benefits help families with children maintain an adequate standard of living after the worker's retirement. A child's benefit is equal to one-half of the parent's basic benefit, subject to a dollar limit on the maximum amount receivable by any one family. If such benefits were eliminated for the children of retirees aged 62 through 64, beginning with retirees reaching age 62 in October 1987, the savings would total about $1.8 billion over the next five years.

This option might encourage some retirees to stay in the labor force longer. At present, though benefits for retired workers and their spouses are actuarially reduced if retirement occurs before age 65, children's benefits are not. Further, the younger the workers are, the more likely they are to have children under age 18. Thus, workers under age 65 now have an incentive to retire while their children are still eligible for benefits. This incentive would be quite small, however, for families in which spouses are also entitled to dependents' benefits, since the maximum family benefit limits the increase in total benefits attributable to eligible children for these households.

On the other hand, for families with workers whose retirement was not voluntary--because of poor health or unemployment, for example--the loss in family income might cause some hardship. Moreover, since spouses under age 62 receive benefits only if their children under age 16 also receive benefits, eliminating children's benefits for families of early retirees would also result in the loss of spouses' entire benefits in some families. In such cases, the total loss of income could be significant.

ENT-17 ELIMINATE CERTAIN VETERANS' COMPENSATION PAYMENTS FOR THOSE WITH LOW-RATED DISABILITIES OR END ALLOWANCES FOR DEPENDENTS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Eliminate Compensation for Low-Rated Disabilities						
Budget Authority	1,300	1,350	1,450	1,450	1,550	7,100
Outlays	1,200	1,350	1,400	1,400	1,550	7,000
End Certain Dependents' Allowances						
Budget Authority	210	220	230	240	240	1,130
Outlays	190	220	230	230	240	1,110

Veterans' disability compensation provides cash benefits to about 2.2 million veterans with service-connected disabilities. Compensation is based on a rating of their impairments and an average reduction in ability to earn wages in civilian occupations. The disability ratings represent 10 percent differences in functional limitations or severity of the impairment, whereby some veterans may also be categorized as "unemployable" if their rating is 60 percent or higher. Additional allowances are paid to veterans with disabilities rated 30 percent or greater and who have dependent spouses, children, or parents.

Eliminating cash benefits for those with disability ratings below 30 percent would reduce federal outlays by about $7.0 billion between 1988 and 1992. About 1.2 million veterans would lose all their cash benefits (currently between $69 and $128 per month), but they would retain their eligibility for medical care and other associated benefits. Alternatively, ending only the dependents' allowances for those with ratings below 60 percent would save $1.1 billion between 1988 and 1992. For about 410,000 veterans whose disability ratings are 30 percent, 40 percent, or 50 percent and who have dependents, benefits would be reduced by an average of about $40 per month.

Advocates believe each option would target benefits toward the most impaired and perhaps the medically neediest of the disabled veterans and

their families. The first option would bring compensation for disabled veterans more in line with workers' compensation programs, which generally provide only temporary cash or medical benefits for low-rated impairments. It would also link the compensation more closely with performance on civilian jobs that depend less on physical labor than when the associated cash payments were originally set. Because of the availability of and improvements in reconstructive and rehabilitative medicine, proponents question whether veterans with impairments rated below 30 percent suffer any reductions in their earnings as a result of their low-rated disabilities. Many of these veterans are compensated for physical impairments such as mild arthritis, moderately flat feet, or one partially amputated finger, which may not affect their ability to work.

Similarly, proponents of the second option argue that the rising participation of women in the labor force means that dependents' allowances for veterans with disability ratings of 30 percent to 50 percent are often not necessary to maintain adequate family incomes. Moreover, they contend that veterans with ratings below 60 percent are likely to be fully employed and able to provide for their families.

Opponents, however, view these benefits as indemnity payments owed to veterans disabled to any degree while serving in the armed forces. Furthermore, older beneficiaries who have retired from work may rely heavily on their compensation income, so that even a small reduction in payments could have a greater impact on them than on younger veterans. Other disabled veterans might find it difficult to increase their working hours or otherwise manage to make up the loss in payments.

An alternative option would be to reduce or eliminate benefits to veterans with low-rated disabilities who have already received their benefits for more than a certain number of years. For example, eliminating compensation for those veterans with disabilities rated below 30 percent after the initial two years of payments would result in only slightly smaller savings over the next five years. At the same time, it could provide benefits to these veterans when some might most need them.

ENT-18 REQUIRE A TWO-WEEK WAITING PERIOD FOR UNEMPLOYMENT INSURANCE BENEFITS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Budget Authority	--	--	--	--	--	--
Outlays	--	1,200	1,300	1,450	1,500	5,450

NOTE: These estimates assume that the change is not implemented until fiscal year 1989, to allow time for changes in state Unemployment Insurance laws.

Current federal law imposes no mandatory waiting period before jobless workers can receive Unemployment Insurance (UI) benefit payments, although the Omnibus Reconciliation Act of 1980 does require states to adopt a one-week waiting period on regular UI benefit payments or lose some federal benefits under the extended UI program. About three-quarters of the states now require a one-week waiting period for regular UI benefits.

If all jobless workers were required to wait two weeks before receiving UI benefits, program outlays would be reduced and beneficiaries in all states would be treated uniformly. Such a change would not affect the maximum length of time during which workers could collect benefits; for example, a person otherwise eligible for 26 weeks of benefits would retain that eligibility but would receive payments during weeks 3 through 28 of joblessness. Benefits would be reduced, however, for those recipients not using the maximum number of covered weeks. If implemented in 1989 (to allow time for states to change their UI laws), this option would cut UI outlays by nearly 8 percent, or by about $5.5 billion between then and 1992.

This option could significantly reduce the incentive of workers to become unemployed and collect UI benefits by increasing the initial cost of joblessness, yet it would not greatly affect the program's ability to help the long-term unemployed. Restricting aid in this way might lower the number of workers who apply for assistance and reduce the duration of benefits paid to many who do apply.

On the other hand, because this change would reduce the benefits provided to jobless workers who do not use all of their entitlement, it would

diminish the income support role of UI. In addition, opponents maintain that covered workers are entitled to benefits when they become unemployed, and that this change would erode the insurance protection of UI. Finally, some people oppose this change because it would impose additional federal restrictions on state UI programs, even though it is state UI taxes that finance regular UI benefits.

ENT-19 INDEX THE UNEMPLOYMENT INSURANCE TAXABLE WAGE BASE

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1988	1989	1990	1991	1992	
Addition to CBO Baseline	--	0.2	0.6	0.7	0.6	2.1

NOTE: These estimates assume that the change is implemented in January 1989, to allow time for changes in state laws. Further, some states with Unemployment Insurance programs in good financial condition are assumed to offset at least part of the increases in the state tax base with reductions in state tax rates.

The joint federal/state Unemployment Insurance (UI) program is financed primarily through federal and state payroll taxes on employers. The federal UI taxable wage base--which also serves as the minimum base for state UI taxes--is currently $7,000 per worker and has been increased only three times from its level of $3,000 in 1940. The proportion of total wages subject to the federal tax has thus fallen from over 90 percent in 1940 to less than 40 percent now. In contrast, UI benefits tend to increase with nominal wages, because benefits are based in part on prior earnings and because many states index their maximum weekly benefit to average weekly wages. Indexing the federal UI wage base by linking it to national average earnings--as is done with the Social Security base--would increase combined federal and state UI revenues by about 3 percent, while reducing the federal budget deficit by about $2.1 billion over the 1989-1992 period. This estimate of the budgetary effect includes the reduction in income tax revenues that would result from the UI tax increase.

This option could help stabilize the long-term financial position of the UI system by allowing revenue increases to follow a path similar to benefit gains. Revenue from the federal UI tax would increase nearly in proportion to the rise in the base. State UI tax receipts also would increase, although probably less than proportionately because many states whose UI programs are in good financial shape would be likely to reduce their tax rates. Overall, state tax rates have risen from an average of 1.3 percent of taxable wages in 1970 to about 2.7 percent in 1986. Finally, by concentrating the tax increase on the wages of workers now earning more than the current tax base, this change would make the UI tax somewhat less regressive than it is now.

Because this change could result in higher labor costs for employers, however, it might adversely affect employment levels. In addition, mandating increases in minimum wage bases for state UI taxes would limit somewhat the flexibility of states in designing tax systems to finance their UI benefits. Although states in good financial condition could offset the total amount of this change by lowering tax rates, there would be some redistribution of tax payments by different firms.

ENT-20 MAINTAIN THE CURRENT FEDERAL UNEMPLOYMENT INSURANCE TAX RATE

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1988	1989	1990	1991	1992	
Addition to CBO Baseline	0.7	0.8	0.8	0.5	0.3	3.1

Under current law, the minimum net federal Unemployment Insurance (UI) tax rate is 0.8 percent for the first $7,000 paid annually to workers. One-quarter of this tax rate--or 0.2 percent--is a temporary amount added to repay certain outstanding loans from the general fund of the U.S. Treasury to the Unemployment Trust Fund. These loans are expected to be repaid during 1987, so that under current law the rate would be reduced to 0.6 percent beginning in January 1988. Maintaining the present rate of 0.8 percent would increase combined federal and state UI revenues by about 4 percent, while reducing the federal budget deficit by about $3.1 billion over the 1988-1992 period. This estimate of the budgetary effect includes the reduction in income tax revenues that would result from maintaining the higher UI tax rate.

Under this option, balances in the federal UI accounts in the Unemployment Trust Fund are projected to reach their statutory maximums beginning in 1988. The excess funds would be transferred to the states' UI accounts, probably leading some of them to lower their UI tax collections. Such an offsetting reduction is also reflected in the budgetary estimates.

Some proponents argue that the additional UI revenues collected under this option could be used to finance extended benefits in the next recession. Others contend that some of the funds could be used to train unemployed workers, thereby potentially reducing the long-term costs of UI, although in this case the near-term deficit would be reduced by less. In addition, supporters point out that this option would increase program revenues without imposing additional restrictions on the states' UI programs.

Opponents contend, however, that once the UI loans from the Treasury are repaid the need for this added revenue will be eliminated and the tax rate should be lowered as planned. Further, because this option would not allow labor costs for employers to fall, it would lead to somewhat less overall employment than under current law.

ENT-21 REDUCE AND RETARGET AID FOR DEPENDENT CARE

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Gross Revenue Gain	270	1,800	2,000	2,150	2,350	8,550
Outlays a/	135	900	1,000	1,075	1,175	4,275
Net Savings	135	900	1,000	1,075	1,175	4,275

a. Negative numbers reflect increased outlays for the SSBG (see text) and assume 100 percent spend-out of additional SSBG budget authority in each year.

The federal government provides financial support for dependent care through the Dependent-Care Tax Credit and the Social Services Block Grant (SSBG). The tax credit permits taxpayers to reduce their federal income tax liabilities by a specified percentage of employment-related expenses for care of children under age 15 and certain other dependents. The credit is granted on a sliding scale--30 percent of up to $4,800 in allowed expenses for taxpayers with adjusted gross incomes (AGI) of $10,000 or less, declining one percentage point for each additional $2,000 of AGI to 20 percent for those with incomes above $28,000. The SSBG funds a wide variety of social services, including day care for children and other dependent people.

Tightening the tax credit and expanding the SSBG--with the stipulation that the additional funds be used for dependent care for low-income families--would reduce the deficit while expanding services for those most in need. The tax credit could be more steeply graduated than it now is, declining by one percentage point for each additional $1,000 of AGI over $10,000 and phasing out completely for those with an AGI above $39,000. If half of the additional revenues were applied to the grant program, the net reduction of the deficit would be $135 million in fiscal year 1988 and $4,275 billion over the 1988-1992 period.

This option would help meet the growing need for dependent-care services for low-income families. For example, about 5 million children under age 6 lived in poverty in 1985--an increase of 1.5 million since 1979--and 56 percent lived in single-parent households. The families of these children can have difficulty obtaining high-quality child care without assistance, and

because of their low incomes, few benefit from the tax credit. This option would also reduce work disincentives for some low-income parents by offsetting some of the expense associated with going to work.

On the other hand, these measures would require a partial reversal of some recent changes in federal support for dependent care. In creating the SSBG in 1981, the Congress removed the requirements of the predecessor program (Title XX) that benefits be targeted by income and that a specified amount of funding be spent on child care. Moreover, tightening the credit would adversely affect some families--including some with incomes below the median--by increasing their tax liabilities.

AGRICULTURAL PRICE SUPPORTS

Outlays for the Department of Agriculture's price and income support programs have far exceeded levels estimated at the time the Food Security Act of 1985 was passed. Current projections place Commodity Credit Corporation outlays at nearly $75 billion for the three-year period 1986-1988. By comparison, a CBO projection made soon after the bill was signed foresaw outlays of about $64 billion over the same three-year period. Other estimates used by the Congress had been even lower, in the $50 billion to $55 billion range.

Several factors account for this disparity in projected program costs. Good harvests at home and abroad have added to domestic supplies and reduced the demand for U.S. exports. Moreover, expectations of increased sales of U.S. products in response to substantial price reductions appear to have been too optimistic.

The high outlays on farm programs, coupled with concern that the current policies are not working to promote an efficient and competitive agricultural sector and that benefits are not being distributed equitably, have again focused public attention on this sector. At least three general approaches have been put forward:

- Leave current farm programs basically intact while making marginal changes that would reduce outlays. This approach might also include a reduction in benefits to farmers not in need of federal assistance.

- Raise domestic farm prices through higher nonrecourse loan rates coupled with production or marketing controls, while maintaining export markets with explicit export subsidies.

- Cut the link between income support and farmers' production decisions; allow market signals to determine production and resource use.

Current Policy. Proponents of leaving current policy intact argue that it has not had enough time to bring about the responses of producers and users that would lead to reduced program costs and increased U.S. exports. Two

budget reduction options (AGR-01 and AGR-02) are discussed that would reduce spending without fundamentally changing the present approach to farm policy: relatively small reductions in target prices and increases in unpaid acreage reduction requirements. Commodity prices would still be affected by the current commodity loan programs, and income support would be provided through deficiency payments.

An additional budget reduction option that might fit within this approach would be to redirect farm program benefits toward farmers judged to be in need of federal assistance (AGR-03). (Such targeting of assistance toward particular groups of farmers could, of course, be combined with more fundamental policy changes.) Budget savings in this case would be achieved primarily by reducing payments to large farmers or those who are presumably less in need of assistance.

Another option that would not fundamentally affect current policy would be to change the Department of Agriculture's generic certificate program to reduce what many view as unintended benefits to farmers and other recipients of the certificates, and the corresponding unintended costs to the federal government (see AGR-04).

Higher Prices. Supporters of raising domestic farm prices argue that under current law farmers are forced to rely heavily on government payments because market prices are too low. Some advocate mandatory production or marketing controls to increase domestic prices and reduce the need for government payments. In order to maintain foreign markets, exports would be subsidized. An alternative examined here (AGR-05) would allow the Department of Agriculture to manage supply through authority already available to it, such as paid acreage diversion, with the aim of raising domestic prices and reducing government payments. The specific option examined is a 20 percent increase in domestic price levels, a much smaller increase than contemplated in most mandatory control proposals.

Decoupling. Advocates of cutting the link between income support and production decisions claim that current programs encourage farmers to overproduce, and also impede the shift of resources from agriculture to other sectors of the economy. "Decoupling" income support and production decisions would allow production to respond to market signals and make agriculture adaptable. Decoupling could take a variety of forms. The option discussed (AGR-06) would replace deficiency payments with an income support payment unrelated to current production.

AGR-01 REDUCE DEFICIENCY PAYMENTS BY LOWERING TARGET PRICES

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Budget Authority	350	1,100	1,350	1,450	1,750	6,000
Outlays	350	1,100	1,350	1,450	1,750	6,000

Current law allows the Secretary of Agriculture to reduce target prices from levels announced for the 1987 crops of wheat and feed grains by 2 percent in 1988, 3 percent in 1989, and 5 percent in 1990. Cotton and rice target prices can be reduced by 2 percent, 3 percent, and 2 percent over the same period. The CBO baseline assumes that the reduction would be continued in later years. Budget savings could be achieved by reducing target prices faster than allowed in current law. The greater the rate of reduction, the greater would be the savings. One alternative would be to reduce target prices by 5 percent per year starting with the 1988 crops. Outlay savings would be $6 billion over the 1988-1992 period.

A more rapid rate of target price reduction would increase the pace at which farmers begin to respond to market signals in making production decisions, rather than seeking to maximize government program benefits. What some view as a necessary reduction in the resources devoted to agriculture, often referred to as "downsizing," would take place faster if income support were reduced. Others point to the level of target prices relative to market prices as sufficient evidence that they are too high. The current target price for wheat is about 90 percent higher than the projected season average price. The target price for corn is about 70 percent higher, and the target price for cotton about 55 percent higher, than their projected market prices. The target price for rice is more than double the projected price.

Lowering target prices reduces farm income, and would affect some farmers' ability to remain in agriculture. In 1985, over half of deficiency payments went to farmers considered to be financially stressed, a finding that might be cited by both opponents and proponents of this option. On the one hand, most payments are made to farmers whose survival may depend on their receipt. On the other hand, a large amount of payments go to farmers

without high debts or negative cash flow, a group who might be considered not to need financial assistance.

In order to be eligible for deficiency payments, farmers must agree to place some portion of their base acreage in a conserving use rather than in their cash crop. Large reductions in deficiency payments might cause many to withdraw from the acreage reduction program, and lead to some offsetting federal costs if additional surplus production had to be removed from the market. But current incentives to participate are so strong that relatively small reductions in target prices, as in this option, would not have substantial effects on program participation.

AGR-02 INCREASE REQUIREMENTS FOR UNPAID ACREAGE REDUCTION

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Budget Authority	900	1,650	1,500	1,400	1,400	6,850
Outlays	900	1,650	1,500	1,400	1,400	6,850

Participants in current price and income support programs are required to set aside some portion of their land normally planted to program crops in order to be eligible for deficiency payments, nonrecourse loans, and marketing loans. The Secretary of Agriculture's discretion to determine the set-aside requirement is limited by law. The maximum requirement allowed on unpaid acreage reduction is 30 percent in the wheat program, 20 percent in feed grains, 25 percent in cotton, and 35 percent in rice. Increasing the requirements for unpaid acreage reduction when excessive stocks exist would permit reductions in federal outlays. A five-percentage-point increase would result in estimated savings of $6.9 billion over the 1988-1992 period. Savings would be achieved in the feed grains programs by substituting unpaid acreage reduction for paid land diversion, which is assumed in the current policy baseline. In the wheat program, savings would result from lower deficiency payments and lower costs of the nonrecourse loan program stemming from reduced production. No cotton or rice program savings are estimated because the current maximum unpaid acreage reduction requirements in these commodities are sufficient to eliminate excessive stocks.

An increase in the requirements for unpaid acreage reduction would mean lower returns to farmers. This decrease would come about in two ways: through lower crop sales and through lower deficiency payments. Opponents argue that farmers cannot afford further reductions in their incomes. They also point to adverse effects on farm suppliers, grain handlers, and others.

AGR-03 TARGET INCOME SUPPORT PAYMENTS TOWARD SPECIFIC GROUPS OF PRODUCERS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Budget Authority	600	1,450	1,300	1,200	1,200	5,750
Outlays	600	1,450	1,300	1,200	1,200	5,750

Income support payments to farmers have risen significantly under the Food Security Act of 1985. The act maintained target prices on major crops at relatively high levels. The government payments are distributed generally according to production levels, with large farmers getting the bulk of the payments. An alternative would be to change the distribution of these payments in favor of small farmers or those in greater need. Redistribution alone, of course, would not reduce federal farm spending; total program benefits would also have to be reduced.

One option would be to reduce target prices for all farmers by 10 percent and redistribute half of the outlay reduction among those farmers selected for special assistance. Participation would not have to be restricted to producers of crops currently under price supports, but could be extended to all farmers meeting eligibility criteria. This option would save an estimated $5.8 billion over the 1988-1992 period.

Other targeting options include a system of "tiered" target prices, in which higher target prices--and thus higher deficiency payments--would be made on an initial increment of production. Target prices would decline with later increments, making the average target price, and average deficiency payment, greater for smaller farmers than larger farmers. Benefits and outlay savings would depend on the levels at which the tiered target prices were set. Outlay savings could result if payments to larger farmers were reduced by a greater amount than benefits to smaller farmers were increased. Benefit increases in this option would be restricted to farmers currently growing program crops.

Currently income support benefits are limited to $50,000 of regular deficiency and diversion payments per recipient and $250,000 for all payments, including marketing loan benefits and the currently exempt portion

of deficiency payments. An additional targeting option would be simply to reduce these limitations. This option would not be a means of providing additional assistance to those farmers considered to be in need, but would result in savings by enabling lower payments to large farmers.

Proponents of targeting argue that farm program benefits are not going to those most in need. Financial difficulties are forcing some producers out of business although aggregate farm income is currently quite high, partly owing to large government payments. Targeting of benefits could also aid in promoting the family-sized farming enterprise, a traditional goal of U.S. agricultural policy.

Opponents of targeting--particularly of reducing payments to larger farmers--point out that market prices have declined so much that the financial condition of larger farmers who get most of these benefits has not necessarily improved, and that large reductions in support for such farmers might cause severe financial difficulties for them. Opponents also argue that the supply control measures contained in current programs would be weakened if payment reductions made program participation unattractive for large farmers. Also, targeting certain groups of farmers for special assistance might mean rewarding producers who, at least in retrospect, have made poor financial decisions.

AGR-04 LIMIT THE USES OF GENERIC COMMODITY CERTIFICATES

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Budget Authority	410	400	260	230	100	1,400
Outlays	410	400	260	230	100	1,400

The Department of Agriculture currently provides generic commodity certificates in lieu of cash for some payments to participants in price and income support, export enhancement, and other programs. These dollar-denominated negotiable certificates can be used by producers to repay outstanding nonrecourse loans, can be exchanged by producers or traders for commodities owned by the Commodity Credit Corporation (CCC), or, after a period, may be exchanged for cash. In 1987, $5 billion to $6 billion in certificates are expected to be issued.

These certificates, and the methods currently used to convert them into quantities of commodities, result in increases in Commodity Credit Corporation outlays that exceed the apparent savings from issuing benefits in certificates rather than cash. One popular use, which clearly causes additional federal outlays, is known as "Quick-PIK." In this transaction, a producer places his or her crop under loan at the nonrecourse loan rate and immediately takes it back using PIK certificates, with the exchange taking place at the posted county price (PCP), which can be considerably below the nonrecourse loan rate.

For example, a corn producer places 1,000 bushels of a crop under loan with the CCC at the local loan rate of $1.80 per bushel, thus receiving $1,800. If the producer has received a generic PIK certificate with a face value of $1,500 in lieu of a cash deficiency payment of that amount and the PCP that day is $1.50 per bushel, the certificate can be used to pay off the loan. The producer has transformed a certificate that was received in lieu of $1,500 in cash into $1,800 through this transaction. He or she takes back title to the crop and can sell it at the local market price (which is likely to exceed the PCP), feed it to the livestock, or store it for later sale or use. The transaction has cost the government $300 more than if the original deficiency payment had been made in cash.

Eliminating the Quick-PIK transaction, or requiring current crop loans to be paid off at the loan rate rather than the lower PCP, would save an estimated $1.4 billion over the 1988-1992 period. PIK certificates could still be exchanged for CCC stocks, used to pay off farmer-owned reserve loans, or exchanged for cash. Producers would be no worse off than had they received the original payment in cash, but would lose the benefits of profiting from this transaction.

Proponents of this change argue that the gain realized by producers was not intended by the 1985 act, which authorized use of these certificates, and that the increase in federal outlays is unwarranted. They argue that this transaction has no beneficial effects on the market but is basically a subsidy to farmers and other recipients of certificates.

Opponents argue that the use of generic PIK certificates, and this Quick-PIK transaction in particular, causes prices to be lower than they would otherwise be and encourages increased use of surplus commodities. They also disagree as to the costs of these certificates.

AGR-05 RAISE DOMESTIC PRICES OF SUPPORTED AGRICULTURAL COMMODITIES

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Budget Authority	120	-1,800	900	980	1,730	1,930
Outlays	120	-1,800	900	980	1,730	1,930

The 1985 farm bill sought to make U.S. commodities more competitive in world markets by across-the-board price reductions for both domestic and foreign users. An alternative would be to raise domestic prices while using export subsidies to maintain competitive prices on world markets. If, for example, nonrecourse loan rates for wheat and feed grains were increased sufficiently to raise domestic prices 20 percent above baseline levels in 1988-1992, using export subsidies to maintain exports at levels currently projected, federal outlays would be reduced by an estimated $1.9 billion over the period. This estimate assumes increased use of diversion payments to reduce acreage, as permitted under current law. For some crops, import controls might be needed to limit competition from lower-priced foreign production.

Price increases of this magnitude could be accomplished without accumulating stocks, assuming a relatively small reduction in production through paid land diversion. Most of the federal outlay savings from this option would come from a reduction in support payments to farmers, who would get higher prices from domestic sales. Proponents of such a plan argue that the budget savings would justify the somewhat higher price paid by domestic consumers; prices would still be lower than if the policies of the 1981 farm act had been continued. Proponents also argue that some foreign producers, notably in the European Community, currently have such two-price systems, and that the present approach to competing with them is unduly expensive.

Opponents argue that potential increases in food prices, though quite small in this particular option, would be at the expense of low-income people who spend a relatively large proportion of their income on food. They also argue that such export subsidies would conflict with U.S. trade policy objectives.

AGR-06 REDUCE EFFECTS OF INCOME SUPPORT PAYMENTS ON PRODUCTION DECISIONS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Budget Authority	50	950	-750	250	1,400	1,900
Outlays	50	950	-750	250	1,400	1,900

Price support programs are often criticized as encouraging farmers to overproduce. Some analysts argue that a more efficient agricultural sector, and one more adaptable to changing market conditions, would result from the separation, or "decoupling," of government price supports from production decisions.

One approach would completely separate income support payments from the need to produce the traditionally supported program crops. Payments would be based on a production history for a fixed period, would not rise or fall with market or growing conditions, and could be made to decline over time by some fixed formula. The payments would not depend on whether or not a producer grows a particular crop or on the market price received for the crop. If phased out over time, they could be regarded as a means to support farmers during a transition period in which the farm sector returns to generally free market conditions. A nonrecourse loan, offered at rates below the expected market price, could be used to mitigate the effects of sharp, unanticipated price drops. Some production controls could be employed early in the transition to assist the market in making an orderly move toward less government-dominated conditions.

The cost estimate shown is for one possible specification of this policy option. Direct payments are made to producers of wheat, feed grains, and soybeans. Payments are based on production histories with payment rates being set so that 1988 gross returns are approximately 85 percent of levels projected under current policy. Payments are disbursed using a schedule similar to that now used for making deficiency payments and are assumed to be phased out over a six-year period.

Costs or savings of this option are very sensitive to the choice of payment level and its rate of decline through time. Federal outlays would

also be affected by the CCC's disposition of existing stocks, the level of nonrecourse loan activity, and other factors.

Proponents of such a measure argue that an efficient, competitive, and adaptable agricultural sector can only evolve if farming is responsive to market forces. Proponents also point out that this option would make federal spending for agriculture far more controllable and would contribute to better budget planning. Transition payments would also make it easier for some farmers to move out of agriculture into other pursuits.

Opponents argue that to eliminate or weaken price and income stabilization would harm producers and consumers alike. They also believe the measure might lead to sizable reductions in farm land values. Finally, farmers whose crops are not now covered by price supports could eventually face competition from the recipients of transition payments.

NONDEFENSE DISCRETIONARY SPENDING

Spending for nondefense discretionary programs totaled $170 billion in 1986. Programs in this category, which require annual appropriations, include assistance to business and commerce (9 percent), programs providing benefits or services to individuals (35 percent), spending to develop or maintain transportation and other infrastructure (20 percent) and energy and natural resources (10 percent), civilian research and development programs (9 percent), aid to foreign governments and international organizations (8 percent), and justice and general government (9 percent). (These totals include compensation for civilian employees of nondefense agencies, discussed in the Federal Work Force section.)

SPENDING SINCE 1980

Through the late 1970s, nondefense discretionary spending maintained about a 5.5 percent share of gross national product (GNP). Since 1984, however, outlays in this category have accounted for just over 4 percent of GNP. Spending power has fallen 23 percent since 1980, and the share of nondefense discretionary outlays has dropped from around a quarter to just over one-sixth of total federal outlays. The composition of spending within this category has also changed since 1980, reflecting both reduced spending levels and changing federal priorities.

Spending on general government functions, transportation, and the administration of justice remained more or less unchanged (after adjusting for changes in general price levels) between 1980 and 1986. Within transportation, however, spending shifted markedly toward highways, where a 16 percent increase was offset by lower spending for other transport modes.

Spending in all other areas fell (after price adjustments) between 1980 and 1986. Outlays for energy fell by two-thirds; natural resources and agricultural credit, research, and services by one-third; and international affairs by one-fifth. The decline in international spending derives mostly from a 12 percent spending cut in 1986 that reversed earlier increases; the decrease in discretionary spending in agriculture results from a sharp reduction in its credit component.

Federal funding for elementary and secondary education programs increased slightly between 1980 and 1986, but declined by about one-quarter in real terms. Discretionary aid for postsecondary education increased by approximately one-third between 1980 and 1986, thereby declining slightly in real terms. Appropriations for employment and training assistance declined substantially, largely because the Congress eliminated public service employment (PSE) programs. Federal support for housing and community and economic development also fell substantially between 1980 and 1986.

RECENT DEVELOPMENTS

The Congress increased 1987 funding for education programs over 1986 levels. Appropriations for elementary and secondary education rose by more than 10 percent in real terms, with major increases in funding for Chapter 1, education for the handicapped, and aid to combat drug use. Appropriations for nondefense discretionary aid for postsecondary education students increased slightly in real terms between 1986 and 1987. In addition, the 1986 reauthorization of the Higher Education Act included changes in many postsecondary education programs.

Funding for community development programs remained about the same between 1986 and 1987, thereby declining in real terms. Although funding for housing fell by almost 20 percent in real terms, the number of additional housing units receiving assistance declined by less than 10 percent because the Congress shifted some aid to short-term vouchers. Finally, changes in medical care provided through the Veterans Administration targeted assistance more directly toward service-disabled and poor recipients.

Legislation passed in 1986, however, has made changes that will have long-term effects on federal responsibilities for funding certain facilities and services. Passage of the Omnibus Water Resources Development Act of 1986 established new rules for sharing some construction and operating costs with users and sponsors of projects for navigation, flood control, power, and other uses of water resources. The Federal Employees Retirement Act of 1986 required the U.S. Postal Service to carry a greater portion of the retirement costs for its work force, thus reducing an indirect subsidy. Finally, the 1986 Comprehensive Omnibus Budget Reconciliation Act reduced direct postal subsidies by changing the accounting rules by which they are calculated.

Political, economic, and technical events during 1986 will also affect nondefense discretionary spending. Ongoing changes in international capital

markets have dried up the bulk of the subsidies conveyed in Export-Import Bank loans--all borrowers except those from the poorest developing countries now pay market terms. The accident that destroyed the space shuttle Challenger in January has changed space policy to a new strategy of using both unmanned rockets and manned shuttles to get payloads into space. This change may call into question plans for both replacing the Challenger and constructing the international space station.

Policies to revise the federal role in transportation also advanced in 1986. The sale of Conrail was approved in legislation that will provide around $2 billion in offsetting receipts in 1987. Moreover, under direction from the Congress, Amtrak has, since 1982, markedly improved its financial performance. During 1986, revenues rose by 4.3 percent while costs were cut by 2.3 percent. As a result, 62 percent of Amtrak's systemwide costs were covered from revenue, and its subsidy declined from $684 million in 1985 to $590 million. A plan to transfer Dulles and National airports to a regional commission in 1987 was approved. In the future, federal costs for the airports will be limited to the subsidy associated with issuing tax-exempt bonds to finance capital improvements.

The major environmental policy enacted in 1986 was the reauthorization of Superfund (the Comprehensive Environmental Response, Compensation and Liability Act of 1980). This legislation established a $9 billion, five-year cleanup program, to be financed from a combination of federal revenues and special taxes, that continues a trend toward greater federal outlays to address hazardous waste and toxic pollution. Other major environmental issues, including reauthorizing the Clean Water Act and controlling acid rain, have not yet been resolved.

Budgetary issues for energy development include possible responses to the depressed state of the oil and gas industries and proposals for reorganizing the power marketing administrations.

OPTIONS FOR REDUCING FUTURE SPENDING

The detailed options that follow for nondefense discretionary (NDD) programs are grouped to reflect different rationales for budgetary savings. All of the options presented here would cut nondefense discretionary spending by reducing federal activity. In addition, NDD-04 to NDD-11, would reduce federal support for programs whose goals either have been achieved or could be achieved even with lower spending levels. Options NDD-12 to NDD-16 would achieve savings by improving the efficiency of federally supported

services, principally through greater reliance on user-fee financing. Unlike other options, this group typically envisages that others--users or state and local governments, for example--could increase their share of costs to make up for reduced federal spending. NDD-17 and NDD-18 would improve targeting of federal aid by eliminating or reducing spending for less needy recipients. The last group, NDD-19 to NDD-24, would eliminate federal support for activities with uncertain or distant future payoffs. Some options reflect more than one of the above rationales. For example, NDD-19 would either eliminate Community Development Block Grants because the assistance may not meet national goals or would limit eligibility for the grants to those jurisdictions most in need of assistance.

None of the options discussed in this section relies on revenue from asset sales to reduce the deficit during 1988-1992. Criteria used to select items for discussion applied a joint test that options both (a) reduce deficits within the 1988-1992 period, and (b) result in long-term reductions in federal (net) outlays. Thus, selling the Naval Petroleum Reserve is not discussed since the revenue from asset sales during 1988-1992 would be offset by the long-term loss of revenue from oil sales. Options that envisage asset sales (see NDD-16) estimate budgetary savings only for lower costs of operating assets or providing services, not for the proceeds of asset sales. (Alternatively, NDD-02, NDD-04, and NDD-15 discuss direct reductions in such operating subsidies.) Issues surrounding budgetary treatment of asset sales are discussed in Section I.

NDD-01 REDUCE FEDERAL SUPPORT FOR AGRICULTURAL RESEARCH AND EXTENSION ACTIVITIES

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Budget Authority	300	310	330	340	350	1,630
Outlays	230	270	300	310	320	1,430

The Department of Agriculture's Agricultural Research Service (ARS) and Cooperative State Research Service (CSRS) conduct and support agricultural research. ARS is the in-house research arm of the department, operating at locations throughout the country. CSRS provides support for research conducted at land-grant universities and other eligible state institutions. The Extension Service (ES) educates farmers and other rural residents in farming methods and conducts a nutrition education program aimed at low-income families throughout the country. The 1987 appropriation for these agencies totaled $1.1 billion. Reducing funding levels by 25 percent would save $1.4 billion over the 1988-1992 period.

Proponents of reducing support for these activities believe that federal research often works at cross-purposes with other federal policy goals. Some argue that money spent on research aimed at increasing productivity in these times of substantial surplus production could be better spent elsewhere. Furthermore, some research directly benefits groups that should either conduct it themselves or share in its cost. Others argue that government research may result in larger, more capital-intensive farms rather than maintaining family-sized farming operations.

Advocates of reducing activities of the Extension Service cite the relatively large portion of the ES budget that does not benefit farmers. The President's 1987 budget contained a proposal to eliminate most ES activities other than those directly aimed at assisting active farmers.

Opponents point to the importance of both research and extension in the development of an efficient agricultural sector. They cite the benefits to consumers and the need to maintain the competitive position of U.S. farmers in world markets.

NDD-02 REDUCE NEW LENDING OR INCREASE HOMEOWNERS' PAYMENTS UNDER RURAL HOUSING LOAN PROGRAM

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Reduce New Lending						
Budget Authority	520	640	580	550	540	2,820
Outlays	500	620	610	610	600	2,940
Increase Borrowers' Payments						
Budget Authority	-15	-30	--	40	80	75
Outlays	35	75	120	160	200	590

The Section 502 housing program, administered by the Farmers Home Administration (FmHA), provides mortgages at effective interest rates as low as 1 percent to enable low-income borrowers to purchase homes while spending only 20 percent of their incomes on mortgage payments, property taxes, and insurance. The FmHA's major cost is the difference between the rates it pays for the funds it borrows to finance the program and the rates borrowers pay for FmHA mortgages. During 1985, more than 40,000 rural households with incomes below a level that ranges between $11,500 and $18,000, depending on area housing costs in the continental United States, purchased single-family homes with loans at reduced interest rates from the FmHA. Two approaches for reducing federal costs under this program are described here.

Reduce New Lending. If new lending under the Section 502 program were halved, the number of new households that would receive the deep subsidies now provided to a small proportion of all eligible households would be reduced. Some critics of this program argue that making such sizable payments to so few households is not the best use of scarce federal resources. On the other hand, this approach would weaken a program that has enabled some low-income rural households to become homeowners. Halving new lending would reduce federal outlays by about $500 million in 1988 and $2.9 billion in the 1988-1992 period.

Increase Borrowers' Payments. A second alternative would continue lending at the present volume but would raise the costs to new borrowers. If, beginning in 1988, new FmHA borrowers paid 28 percent of their incomes for housing costs--the rate now charged under a comparable program sponsored by the Department of Housing and Urban Development (HUD)--federal outlays would be cut by $35 million in 1988 and $590 million in the 1988-1992 period. Thus, this option would eliminate a disparity between the HUD and FmHA programs. On the other hand, increasing the percentage of income that rural households would pay toward housing costs could shift the composition of borrowers away from households with the very lowest incomes. In addition, having higher housing costs relative to income might lead to higher default rates among new program participants.

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NDD-03 REDUCE FUNDING FOR RESEARCH SUPPORTED BY THE NATIONAL INSTITUTES OF HEALTH

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Budget Authority	320	330	350	370	390	1,750
Outlays	140	310	340	360	370	1,520

The federal government will spend about $6 billion for health research funded through the National Institutes of Health (NIH) in 1987. About four-fifths of the NIH research budget is awarded to universities and hospitals through research grants, contracts, and centers. The remainder is spent on research within the Institutes and for administration. If appropriations for NIH research were reduced by 5 percent, the 1988-1992 outlay savings would total about $1.5 billion.

The NIH could reduce research spending in several ways--for example, by reducing the number of grants awarded. Since funding of projects is based on a rating system, proposals with the highest ratings would continue to be supported. The NIH could also limit the overhead costs of research grants, which might have only limited effects on the amount of research actually undertaken. Alternatively, research projects could be funded at 95 percent of cost, thereby encouraging researchers to find additional sources of support for their work.

Advocates of a reduction believe that NIH spending is excessive. They point to its rapid growth--about 50 percent between 1981 and 1986, or 25 percent after accounting for inflation. They also note that operational overhead is consuming a large and growing proportion of NIH's total funding for grants, averaging about 30 percent in 1986.

Opponents of a reduction maintain that cuts could have some adverse effects on the country's biomedical research. They contend that some researchers who receive reduced or no funding might leave the field, because private support would probably not increase enough to offset this reduction. Opponents are especially concerned that cutbacks could seriously hurt research in diseases such as Acquired Immune Deficiency Syndrome and Alzheimer's disease, depending on priorities established by the Congress and the Institutes.

NDD-04 REDUCE SUBSIDIES PROVIDED BY THE RURAL ELECTRIFICATION ADMINISTRATION

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Budget Authority	40	150	240	300	350	1,080
Outlays	40	150	240	300	350	1,080

The Rural Electrification Administration (REA) is an agency within the Department of Agriculture that provides financial assistance to rural electric and telephone cooperatives. In 1973, the Congress set up the Rural Electrification and Telephone Revolving Fund to provide direct loans to rural utility cooperatives at an interest rate of 5 percent, and to authorize the REA to fully guarantee loans made to cooperatives by other lenders. At that time, the 5 percent rate was about 1 percent below the then prevailing long-term Treasury borrowing rate. Since then, however, the gap between the 5 percent rate paid by the cooperatives and the interest rate that the REA pays to finance the direct loans has widened considerably. This gap was near 10 percent in 1984, but has shrunk to less than 3 percent. The REA program provides the cooperatives a twofold subsidy. First, cooperatives can obtain direct loans at below-market interest rates. Second, since the federal government assumes the full risk of the REA guaranteed loans, the cooperatives get financing at below-market cost on funds obtained from non-REA lenders. Budgetary savings could result from modification of loan terms and other changes that reduce these subsidies.

In 1986, the REA provided roughly $960 million in direct loans at the 5 percent interest rate, and financed about 54 percent of these by borrowing from the Federal Financing Bank (FFB). The REA must borrow from the FFB because its lending levels, set by the Congress, exceed its fund income from loan repayments. The REA must pay interest on these FFB borrowings at the Treasury rate which peaked at over 16 percent in 1984, falling to 7.4 percent in 1986, still above the 5 percent rate the REA charges.

Because of this large interest rate subsidy, the Congress has appropriated roughly $520 million since 1984 to the REA fund to cover interest losses. At current lending and appropriation levels, however, the fund

remains in danger of defaulting on its $7.9 billion loan from the Treasury, which is due beginning in 1993, and on some of its borrowings from the FFB. Decreasing the size of the federal subsidy that the REA program provides to utility cooperatives would help reduce the level of future appropriations necessary to keep the fund solvent.

Simply raising the interest rate for REA's direct loans to equal the Treasury rate, however, will not generate significant additional income for the fund during the next decade because the gap between current Treasury interest rates and the REA 5 percent interest charge is small. (The large interest rate subsidy provided by REA loans made in the early 1980s, however, will continue to drain the fund's resources.) To realize further federal budgetary savings, the Congress could lower the ceiling on REA direct loans to about two-thirds of the 1986 new loan level of $860 million. If the REA targeted its direct loans toward those cooperatives most dependent on federal financing, the effect of reducing REA's lending levels would be small and more equitable. (Currently, the REA makes loans to cooperatives without regard to the utility's financial condition, although many REA borrowers are financially healthy enough to obtain financing in the private market.) Taken together, increasing REA's interest rate to equal the Treasury rate and decreasing the levels of REA loan obligations by about one-third would reduce net federal spending by about $40 million in 1988, and by nearly $1.1 billion over the 1988-1992 period.

The REA has largely fulfilled its goal of making electric and telephone service available in rural communities. Proponents of the current REA program argue, however, that many cooperatives still depend on the low-interest REA loans to expand and maintain viable electric services to rural communities. They claim that increasing the interest charges or reducing the amount of REA loans provided to these cooperatives would raise the utility bills of their customers, particularly affecting the more rural, less densely populated regions. Raising the REA interest rate would have little effect on most cooperatives' rates, however, as interest charges account for only a small percentage of the average ratepayer's bill. Furthermore, reducing the level of REA's direct loan program would decrease federal subsidies to the financially sound cooperatives while still providing federal financing to cooperatives that truly need it.

NDD-05 REDUCE FEDERAL FUNDS FOR RESEARCH AND DEVELOPMENT IN ENERGY SUPPLY AND CONSERVATION

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Budget Authority	1,970	2,220	2,340	2,450	2,570	11,550
Outlays	940	1,730	2,150	2,330	2,470	9,620

The Department of Energy (DOE) funds research and development (R&D) in two main areas: new or nonconventional energy-generating technologies (supply R&D) and conservation. Most of the federal funding for these activities is intended to complement, not substitute for, private-sector efforts. However, existing market incentives for developing improved technology for generating energy and to economize on energy use may be sufficient to warrant an extensive reduction of federal support.

In supply R&D, all support for research programs in fossil fuels, solar and renewable resources, energy science, and other areas could be eliminated, assuming that the private sector would continue to support research that appeared commercially promising. Federal support for civilian research in fission power (except funding for cleaning up uranium mine wastes) could also be eliminated because of this technology's high degree of commercialization and the ability of the private sector to conduct appropriate research. However, because the private sector could not reasonably be counted on to continue fusion R&D, which has little immediate commercial value, federal funding in this area would continue. Also, the $400 million already appropriated for research on clean coal technology would be spent in accordance with the current agreement with the Canadian government. (This budget option assumes, however, that the Congress will not appropriate any additional funds for clean coal research.) Eliminating appropriations for all other activities relating to energy supply R&D would result in estimated outlay savings of nearly $915 million in 1988 and $8.9 billion over the 1988-1992 period.

The Department of Energy also provides funding for conservation research and development, including projects on buildings and community

systems, industrial conservation opportunities, and transportation applications. Eliminating these programs would save the federal government $25 million in 1988 and $680 million over the 1988-1992 period.

Critics of reduced support contend that private-sector research efforts may not increase to the overall level experienced when federal R&D support was available, since the returns from successful R&D may be less beneficial to private firms than to society. For example, these uncaptured benefits might include the future security of national energy. Also, short-term economic conditions can inappropriately influence the allocation of private funds intended for long-term technological development. Finally, if private R&D does not compensate for withdrawn federal support, the competitive position of U.S. energy-related products may suffer compared with products developed in countries that maintain high levels of funding for energy-related R&D. Targeting the cutbacks, rather than eliminating funding for supply R&D, could result in substantial savings with minimal disruption of all existing programs.

NDD-06 ELIMINATE ENERGY CONSERVATION GRANTS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Budget Authority	210	220	230	230	240	1,130
Outlays	50	190	210	230	240	920

In addition to conducting research on energy conservation, the Department of Energy (DOE) also distributes grants to state and local governments to finance energy conservation activities. These activities include weatherization of schools, hospitals, and the homes of low-income families. Eliminating this program could save nearly $1 billion over the 1988-1992 period.

If federal support were eliminated, state and local governments could choose to continue such programs themselves, or rely on private incentives for conservation efforts. In addition, states have received nearly $3 billion in the last two years from the settlement of oil pricing and allocation violations, which has been earmarked for energy conservation activities. In many regions, weatherization of public buildings is nearly complete. State and local governments could continue providing funds for low-income families, or encourage public utilities, energy corporations, and even private charities to support weatherization and other conservation efforts. And even at current energy prices, market incentives for increased conservation probably still exist.

Proponents of conservation grants argue that the federal government should continue to encourage conservation even when lower energy prices reduce private incentives (through longer pay-back periods), because the national goal of long-run energy security should not be affected by the short-run economics of world energy markets. Moreover, the federal government has already allowed the tax credit for energy conservation to expire, making weatherization more expensive for individual homeowners. Finally, if oil prices increased once again, low-income families might bear a disproportionate hardship, since their residences tend to be less energy efficient.

NDD-07 CHANGE REVENUE-SHARING FORMULA FROM A GROSS TO A NET RECEIPT BASIS FOR THE NATIONAL FOREST TIMBER SALES PROGRAM

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Budget Authority	240	200	200	200	200	1,040
Outlays	240	200	200	200	200	1,040

The U.S. Forest Service, a part of the Department of Agriculture, manages the National Forest System which comprises 191 million acres--about one-third of all federal lands in the United States. The national forests produce about 20 percent of the sawtimber harvested annually in the United States and contain nearly 1.1 trillion board feet of standing sawtimber, or about 41 percent of the nation's total. Although the national forestlands are a multipurpose natural resource, the forest timber sales program accounts for the largest share of the Forest Service's annual costs and receipts.

Since 1908, 25 percent of federal gross receipts from timber sales has been shared with the representative states and local communities as compensation for lost tax revenues from the federal lands in their boundaries. The costs incurred by the Forest Service in managing the timber resources, however, are expected to exceed the federal share of Forest Service receipts (most of which are associated with timber sales) by about $200 million in 1987. Since payments to states and localities (and the remaining federal share) are based on gross receipts--regardless of costs--there is a tendency to maximize gross receipts. In general, this means a larger harvest than if costs had been taken into account. In many of the timber sales in certain Forest Service regions--particularly the Eastern, Northern, Intermountain, Rocky Mountain, and Alaskan regions--the costs of the Forest Service's timber program exceed the generated gross revenue, even before the states' share is paid. In other regions, particularly the Pacific Northwest and the South, the Forest Service accrues positive net receipts from its timber sales program.

Federal savings would be substantial if the Forest Service would deduct the cost of its timber program from its gross timber receipts before making payments to states and local governments. The regional jurisdictions would continue to receive 25 percent of the Forest Service's net timber receipts, or roughly $25 million in 1987. Some localities (mainly those in the nonprofitable regions mentioned above) would lose all timber receipts from the Forest Service under this proposal. However, local governments also receive money from the federal Payment in Lieu of Taxes (PILT) program, established in 1976 to offset the effects of nontaxable federal lands on local governments' budgets. These PILT payments are partially reduced by the amount of the revenue-sharing payments from the Forest Service. Costs to the federal government under the PILT program would increase, therefore, if the option to share net rather than gross receipts were implemented. These costs have been netted out of the projected savings. Changing the revenue-sharing formula from a gross receipt basis to the more economically efficient net receipt basis would reduce net federal outlays by about $1 billion over the 1988-1992 period.

Deducting costs from gross timber receipts before making payments to local governments would likely reduce the timber harvest on unprofitable timber stands in national forestlands. Although basing the revenue-sharing formula on net receipts would lead to more efficient use of the national timber resources, many local areas that depend on the timber sales program for jobs and federal revenue may be hurt economically under the measure discussed above. To help mitigate this hardship, the Forest Service could switch to the net receipt basis over a period of several years and promote other uses of the forestlands in these areas, such as tourism and recreation.

NDD-08 END FUNDING FOR THE LEGAL SERVICES CORPORATION

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Budget Authority	320	340	360	380	400	1,800
Outlays	320	340	360	380	400	1,800

The Legal Services Corporation (LSC)--an independent, not-for-profit organization established in 1974 legislation--provides free legal assistance to the poor in civil matters. Despite repeated attempts by the Administration to abolish the program, the Congress has continued to fund it. Terminating the LSC would generate five-year outlay savings of about $1.8 billion through 1992. It also would end direct federal funding for legal assistance. States could, however, use federal funds from social services block grants to meet local priorities for legal aid. Such grants totaled $2.6 billion in 1986, about eight times the funding level for LSC.

From its inception, the LSC has been the subject of much controversy. Critics have charged that the activities of legal aid lawyers too often focus on the advancement of social causes rather than on the needs of poor people with routine legal problems. The Administration and opponents of the LSC believe that the responsibility for legal assistance to the poor should rest not with the federal government but with states and localities. From this perspective, support from other federal grants, private sources, and donated services could help to meet local needs for legal aid. Such an approach, critics argue, would give localities more control over legal aid programs, and would thus permit services to be more responsive to local needs.

Advocates of continuing the LSC argue that a specifically targeted federal assistance program is the only way to ensure that legal aid is available to people who cannot pay. They point out that the inadequacy of local and private resources was one of the factors that led to direct federal financing in the first place, and they believe that a strong federal program provides essential oversight and national direction. In response to the continued criticism that LSC lawyers act too often as social activists, proponents of the program point out that restrictions passed by the Congress over the years have already curtailed the activities some observers find objectionable.

NDD-09 SHIFT HOUSING ASSISTANCE FROM NEW CONSTRUCTION TO VOUCHERS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Budget Authority	1,350	1,350	1,400	1,450	1,500	7,050
Lending Authority	410	430	450	470	490	2,240
Outlays	a/	20	130	260	310	720

a. Increase in outlays of less than $2.5 million.

Each year, the federal government makes new 5- to 30-year commitments under various programs to provide rent subsidies for an additional number of low-income households not currently receiving aid. The amounts of each type of additional assistance are determined by the Congress. Rental assistance is provided in two ways: through subsidies tied to projects specifically constructed for low-income households, and through subsidies that enable renters to choose standard housing units in the existing stock of private housing. In recent years, the production-oriented approach has been sharply curtailed in favor of the less costly existing-housing approach. Of the new construction programs administered by the Department of Housing and Urban Development (HUD), only two remain active--the Section 202/8 program for new construction for the elderly and handicapped, and the public housing program. For 1987, less than 20 percent of additional commitments is for construction of new dwellings under these programs, while the remaining incremental aid is provided through the Section 8 existing-housing and voucher programs.

Appreciable savings could be realized by further reducing commitments for the Section 202/8 program--from 12,000 to 4,000, for example--and replacing them with vouchers. This option would slightly increase outlays in 1988 but would save $720 million over the 1988-1992 period, relative to the baseline, with additional savings continuing to accrue for more than 20 years thereafter. Short-term savings in outlays would result primarily from reductions in direct loans to developers of the projects, while long-term savings would accrue because of the lower subsidies associated

with vouchers compared with Section 202/8 aid. (The reduced need for direct loans would also generate savings in lending authority. Savings in budget authority would be derived primarily from the shorter contract term of vouchers--5 years versus 20 years--and, to a lesser extent, from the lower subsidies associated with vouchers.)

Proponents of this option argue that the need for subsidizing new construction is not pressing because the overwhelming housing problem today is not a shortage of rental units but the inability of poor households to afford the rents that existing units command. Furthermore, in many instances, subsidizing new construction merely displaces private activity rather than adding to the housing stock. Thus, proponents conclude, vouchers can help alleviate high housing expenditures for poor households at a faster rate and at much lower cost to the federal government. Proponents also point out that vouchers give households greater flexibility in choosing where they want to live.

Opponents of reducing commitments for new construction contend that national statistics on the supply of rental units mask local shortages in units that are suitable for the elderly and the handicapped and that rent for amounts within HUD's guidelines. They claim that many elderly and handicapped households need housing that can provide special social and physical services not available in their current residence, but that the private sector does not respond adequately. Thus, they argue, the government must continue to stimulate this sort of construction.

NDD-10 PHASE OUT SUBSIDIES FOR FLOOD INSURANCE AND CROP INSURANCE

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Crop Insurance						
Budget Authority	0	110	200	370	530	1,210
Outlays	0	170	310	570	830	1,880
Flood Insurance						
Budget Authority	25	55	85	90	90	345
Outlays	25	60	90	100	110	385

The federal government provides insurance protection against property losses to farmers and to residents of coastal and riparian flood zones. Participants in the crop insurance and flood insurance programs have received subsidized protection against losses, because the premiums that were charged have not covered payments for losses and the administrative costs of running the programs. Shortfalls have been financed with new appropriations and borrowing from the Commodity Credit Corporation and the Treasury.

Savings of $2.3 billion over five years could be realized if premiums were increased to cover the full costs of offering the protection. This action would return the programs to the model of a normal insurance operation, which seeks to have premiums cover payments for losses and administrative expenses (and in the private sector, tax payments and a return on investment). The Administration proposed similar increases in premiums in 1986. The savings estimate in this option assumes that premiums would be increased to actuarially sound levels over three years.

Government provision of flood and crop insurance has often been justified by the nature of the risks against which these programs provide protection. Predicting the timing and severity of floods, droughts, insect infestations, and diseases is inherently difficult. Furthermore, when losses occur, they tend to be catastrophic, affecting many of the insured and being highly concentrated by area. Early attempts by private insurers to offer coverages for these risks led to significant losses, partially because of the lack of

good underwriting information. These insurers also were unable to build up sufficient reserves before the occurrence of catastrophic events. The federal government, in contrast, was able to finance losses in the start-up periods, and had the capability in various agencies (the Geological Survey, the Corps of Engineers, and the like) to develop underwriting standards. Consequently, the government undertook the provision of crop insurance in 1938 and flood insurance in 1968.

When these programs were established, it was not envisioned that the programs would be subsidized over the long run. Development of effective practices for underwriting and adjusting losses has proved difficult, however, and the costs of administering the programs are now very high (exceeding 40 percent of premiums written). But premiums have not been increased to cover these costs and the payments for losses. In the past five years, premiums have averaged less than half of total costs for crop insurance, and three-quarters of total costs for flood insurance.

Both programs have been used for purposes other than providing simple insurance protection. The crop insurance program has provided income support, particularly after 1980 when the subsidy was increased. The goal was to expand participation in the program in order to substitute insurance protection for costly grants and loans for disaster relief. The flood insurance program was subsidized in hopes of providing an incentive to local communities to adopt cost-effective policies for floodplain management. Whether these benefits are worth the costs, however, is not clear. The expansion and subsidization of the crop insurance program did not prevent the appropriation in 1986 of $400 million for disaster relief grants. Nor is it clear that the availability of subsidized flood insurance has substantially improved floodplain management, as zoning standards--when they are enforced--are an effective method of reducing actual losses only in floodplains with minimal development. In areas with preexisting development, the program often subsidizes those who built or bought in floodplains with knowledge of the risks they were taking. Some analysts have suggested that the availability of subsidized insurance actually encourages development in these locations.

If premium increases lead to the withdrawal of substantial numbers of participants--a distinct possibility in both programs as they are currently structured--the programs could end up insuring very small and risky groups of participants. This problem of "adverse selection" could be minimized for crop insurance by requiring participation in the program by those who would want to participate in other USDA commodity programs. Adverse selection for flood insurance could be minimized by requiring all local communities to

participate or become ineligible for any federal assistance. These requirements might be considered too harsh or too intrusive. On the other hand, the insurance mechanism might not work unless similar requirements are adopted. In the long run, it might be more costly if the elimination of disaster insurance were to lead to the frequent use of grants or loans for disaster relief, as was the case in the 1970s.

NDD-11 CONVERT UNDERUSED ACUTE-CARE BEDS IN VA HOSPITALS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Budget Authority	10	120	180	240	310	860
Outlays	35	110	170	230	290	840

The Veterans Administration (VA) provides a wide range of medical and health-related services, and operates 172 hospital centers and 118 nursing homes. The rising demand for long-term care, largely a result of the rapidly increasing number of elderly veterans, has led the VA to expand its number of beds for long-term care, primarily by constructing new nursing homes. About 20 percent of VA hospitals have very low occupancy rates, however, and one-tenth of the total acute-care beds are now used for patients needing long-term care.

If the VA converted its underused acute-care beds to nursing home care, it could scale back plans for the costly construction of new VA nursing homes. In some areas, entire underused VA hospitals could be converted to nursing homes, which would reduce their staffing and equipment costs. Most underused beds would be immediately available for conversion, but delays could occur in some cases since alternative arrangements would have to be made for the current patients. Converting roughly 5,000 of the VA's 77,500 hospital beds would save $35 million in outlays in 1988 and about $840 million over the 1988-1992 period. This savings estimate assumes both higher costs for the alternative arrangements for some current patients and some increased transportation benefits for veterans who might seek care from other VA facilities.

Advocates of such conversions point to the prospect of better suiting VA medical services to the patients being treated. They suggest that, because elderly veterans are a growing proportion of VA patients, an imbalance exists in the ratio of hospital to nursing home beds. Opponents counter that aging veterans will need more acute-care treatment, as well as more services for long-term care. They view the potential closing of hospitals in some areas as reducing access to care for veterans who might prefer care in VA rather than private-sector hospitals.

Legislation would be required to allow the VA to pursue the conversion of a significant number of hospital beds. Current law now requires the VA to staff and operate a combined total of at least 90,000 hospital and nursing home beds, and the conversion process could temporarily lower the total number below that minimum.

An alternative approach would be for the VA to sell some of its underused facilities to operators of private nursing homes. Proponents point out that such a plan would result in considerable federal savings during periods of budgetary stringency, and that it could benefit elderly nonveterans over the long run. Opponents counter that local market conditions might severely limit the VA's net income from the sales. Moreover, they contend that savings from such an option would be partially offset by higher spending by Medicare or Medicaid for nursing home patients, particularly if increases in the number of beds would allow greater use of services in some localities.

NDD-12 RECOVER THE OPERATING COSTS OF SELECTED REGULATORY AGENCIES

Addition to CBO Baseline	Annual Added Revenues (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Addition
USDA	145	300	465	470	480	1,860
FDA	100	205	310	320	325	1,260
FCC	10	20	35	35	35	135
CFTC	10	20	30	30	35	125

The activities of many regulatory agencies benefit regulated industries as well as the general public. Many of these agencies are funded primarily from general revenues. Others charge fees and assessments that raise enough income to meet or exceed the levels of their expenditures. Registration and filing fees for securities, for example, produce receipts that exceed the Securities and Exchange Commission's expenses. Similar cost recoveries could be applied to selected regulatory activities--specifically those of the U.S. Department of Agriculture (USDA), the Food and Drug Administration (FDA), the Federal Communications Commission (FCC), and the Commodity Futures Trading Commission (CFTC). These activities provide specific benefits to identifiable recipients, who could be charged for these benefits in a cost-effective manner. Activities of regulatory agencies that benefit only the general public--dissemination of information, for example--would be left unrecovered. For those areas in which cost recovery is considered, a three-year phase-in is analyzed.

When the USDA inspects the processing of meat, poultry, and other agricultural products, it provides a quality control system for the food industry free of charge. Recovering the full costs of the department's four food inspection services could save nearly $1.9 billion over five years. In its budget for 1987, the Administration proposed similar license and inspection fees, which would be paid by processors to the Treasury.

By assuring doctors and consumers of product quality, the FDA's regulation of drug safety and efficacy benefits the pharmaceutical industry. The costs of the FDA's drug regulation could be recovered from pharmaceutical companies, saving $1.3 billion over five years. In 1985, the FDA itself proposed that the costs of new drug applications be recovered through fees, but this practice has not been implemented. The costs of other drug-related

activities--inspection of manufacturing plants, for example--could be recovered through a general assessment on pharmaceutical company sales.

The FCC could recover all of the costs it incurs in assigning licenses to mass media and private radio operators. These franchises are valuable, since they are awarded from a transmitting spectrum that is physically limited, yet they are awarded at no charge to applicants. The FCC spends a great deal of time and other resources on considering applications. The Consolidated Omnibus Budget Reconciliation Act of 1985 required the FCC to charge fees for reviews, but when fully implemented these fees will recover less than half of the FCC's costs. Were licenses to be awarded instead by auction, administrative reviews might become unnecessary, leading to lower costs. The Administration has proposed an auction of part of the unassigned spectrum in the 1988 budget. Another cost-recovery approach could be to establish a broadcast tax that would capture a portion of the franchise value of existing mass-media franchises. Both the auction and broadcast tax approaches could raise revenues far in excess of the FCC's unrecovered administrative costs. Limiting recoveries to these costs would produce $135 million in additional revenues over five years. (This estimate does not include the common carrier costs of the FCC, which are already exceeded by telephone excise taxes.)

Finally, the CFTC supports public confidence in futures markets by regulating abusive trade practices. The Securities and Exchange Commission performs the same function for the securities markets, while recovering its full costs. If the cost-recovery approach were applied to the regulation of commodity futures, $125 million could be saved over five years.

The clear public benefits these regulatory activities yield might justify financing from general revenues. In addition, many industries oppose regulation, claiming that it constrains profits by setting overly stringent requirements and by needlessly delaying market entry. Cost recovery would add insult to injury for industries that take this position. On the other hand, many of the regulatory activities cited here benefit the regulated industries and are carried out with their general support. The government-provided quality control system for drugs, for example, reduces the pharmaceutical industry's need to insure against liability suits. With budgetary constraints threatening to curb spending on regulation, a shift to user financing might assure the continuation of regulatory activities, or even permit an increase. An example might be new FDA user fees, which could speed up the processing of new drug applications. This effect would only be realized, however, if user fees were dedicated specifically to the agencies' accounts.

NDD-13 END DIRECT AND INDIRECT POSTAL SUBSIDIES

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
End Direct Subsidies						
Budget Authority	160	660	690	720	750	2,980
Outlays	160	660	690	720	750	2,980
End Indirect Subsidies						
Budget Authority	20	35	370	360	-680	105
Outlays	430	1,500	1,700	1,550	420	5,600
Total						
Budget Authority	180	695	1,060	1,080	70	3,085
Outlays	590	2,160	2,390	2,270	1,170	8,580

NOTE: Estimates represent net changes to the federal deficit rather than the USPS budget accounts.

Under current law, direct and indirect subsidies to the U.S. Postal Service (USPS) allow postage rates to be set somewhat below the actual cost of moving the mail. Although recent legislation requires the USPS, beginning in January 1987, to assume the full cost of benefits for all postal workers covered by the new Federal Employees Retirement System, an indirect subsidy will remain because pension benefits for employees who stay under the old Civil Service Retirement system will continue to be underfunded. In addition, direct appropriations to the USPS, called "revenue forgone," burden taxpayers with the costs of postal services for certain preferred mail users--primarily religious and other not-for-profit organizations, blind and otherwise handicapped people, small-circulation newspapers, and libraries. If both the direct subsidies (except those benefiting blind and otherwise handicapped people) and the remaining indirect retirement subsidies were eliminated, five-year outlay savings would total $8.6 billion. The estimated budgetary savings reflect full recovery of postal costs made possible by increased postage rates. The option would eliminate both subsidies in time

for the next general increase in postage rates, assumed in the CBO baseline to occur in June 1988. The USPS, however, has not yet submitted a request for new rates.

With both subsidies eliminated and mailers carrying full postal-service costs, this option would put USPS on a self-financing basis. It would, some analysts suggest, give the USPS an incentive to lower costs by improving management and, at the same time, would eliminate an unfair market advantage that USPS enjoys over competing private-sector firms. Proponents also argue that this option offers a logical conclusion to a trend of declining federal support for postal operations. Since the establishment of USPS as an independent entity in 1972, the Congress has decreased the combined subsidies, including payments for certain public services, from about 25 percent of the full cost of moving the mail to about 11 percent in 1986. The recent changes in retirement financing will decrease the subsidies to less than 4 percent in 1992.

Some observers maintain that subsidies such as special rates for preferred mailers fail to target federal expenditures toward specific national priorities, encourage "junk mail," and provide unnecessary support to many not-for-profit organizations. They point out that such organizations received about $3 billion in federal grants in 1986, and that support in the form of tax deductions for charitable contributions equaled an estimated $15 billion in 1986. In addition, the Postal Rate Commission has recommended to the Congress that direct appropriations be eliminated (except for free mail for the blind and some free categories connected with voting).

Opponents argue that eliminating direct and indirect postal subsidies in 1988 would force mail rates up and volume down. The timing, they say, is especially burdensome because the next postage rate increase already must accommodate the additional financing of retirement and of health care for annuitants levied recently on USPS. CBO estimates that, under current law, first-class postage will rise from 22 cents to 25 cents, and that eliminating indirect subsidies alone would increase rate requirements by another one cent. If both subsidies were eliminated, the cost of preferred-rate mail would rise, on average, about 40 percent. Such rate hikes could pose financial difficulties for some organizations--especially those that depend heavily on mail solicitation for fund raising and those just starting out. Recent changes in the tax law may reduce charitable contributions and thus add to such difficulties.

NDD-14 ELIMINATE FEDERAL SUPPORT TO STATES FOR CONSTRUCTION OF SEWAGE TREATMENT PLANTS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Budget Authority	520	760	1,200	1,740	2,080	6,310
Outlays	5	65	250	520	840	1,680

The Environmental Protection Agency (EPA) provides grants to states and local governments to assist in the construction of local sewage treatment plants. Such plants are required to meet the stringent clean water goals mandated by the 1972 Amendments to the Federal Water Pollution Control Act. Federal participation is deemed necessary to achieve the mandated national goal of clean water. To ensure local compliance with this expensive mandate, the Congress offers the incentive of large federal grants. The government now provides 55 percent of funds for planning, designing, and constructing treatment plants; this share was lowered from 75 percent at the start of 1985.

Current baseline budget projections for these activities call for roughly $2.5 billion in appropriations in 1988, and a total of $14 billion over the 1988-1992 period. If grants for construction of wastewater treatment plants were phased out over seven years beginning in fiscal year 1988, the federal government could save about $5 million in outlays in 1988, and approximately $1.7 billion over the 1988-1992 period.

Critics of the federal wastewater grant program contend that it fosters inefficiency by providing little incentive to seek cost-effective solutions. A community that expects to receive 55 cents on the dollar from federal funds (plus additional subsidies provided by many state treasuries) has less incentive to control construction costs than if it had to pay for the entire investment. Another common criticism is that the 15-year-old program has far exceeded its original planned lifetime of only three years. Furthermore, this program has created a pattern in which communities line up and wait for federal assistance, for periods of as long as 10 years or more. While waiting for federal subsidies, their wastewater discharges violate mandates for clean water, and the quality of streams and rivers shows

little improvement. Finally, some empirical evidence suggests that EPA grants for construction of sewer systems displace municipal expenditures for the same type of project.

Proponents of federal support for construction of municipal treatment facilities argue that states and localities would not be able to meet the goals of the Clean Water Act without federal assistance. Further, some argue that federal participation is justified because the benefits of reduced risk to human health, wildlife, and the environment extend beyond the local community to those downstream from the treatment facility.

As an alternative to the phase-out of federal financing over seven years beginning in fiscal year 1988, the federal government could reduce outlays by providing funds only to those projects begun before 1988, or by extending the phase-out period to more than seven years. Eliminating or curtailing federal subsidies would transfer a large cost burden to states and localities. The EPA has estimated that meeting national needs for construction of wastewater facilities would cost $109 billion by the year 2000, of which about $53 billion would be eligible for federal grants. To meet these needs without federal support--even by the year 2005--states and local jurisdictions would have to spend about $6 billion a year, or about twice current nonfederal outlays.

NDD-15 REDUCE CREDIT SUBSIDIES TO FEDERAL POWER MARKETING ADMINISTRATIONS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Budget Authority	90	220	190	150	130	780
Outlays	360	590	520	460	410	2,340

Federal power marketing administrations--including the Alaska Power Administration, the Bonneville Power Administration, the Southeastern Power Administration, the Southwestern Power Administration, and the Western Area Power Administration--sell electricity at wholesale rates from generating plants owned and operated by the federal government. Capital investments for these power and irrigation facilities are financed by federal appropriations at subsidized interest rates averaging 3 percent. By law, the agencies are required to use income from electricity sales to repay all federal investments within a "reasonable period," though not at a set rate or on a fixed timetable. Because repayments to the Treasury are the first to be deferred when revenues are insufficient to meet all obligations, however, some power marketing administrations have fallen behind in their payments. Moreover, because subsidized rates are lower than the actual costs of government borrowing, the Treasury has lost money through its appropriations to the power marketing administrations.

Requiring the power marketing administrations to repay all federal appropriations on a fixed schedule and at current Treasury interest rates (about 5.1 percent for one-year notes by 1990) would increase Treasury revenues and would thus lower federal outlays by $360 million in 1988 and about $2.3 billion over the 1988-1992 period. (Such receipts enter the budget as offsets to outlays.) These changes could increase electricity rates for wholesale customers in certain service areas. As an alternative--to reduce the effects of a potential price shock on households and industrial customers--the currently subsidized interest rates charged to the power marketing administrations could be gradually raised to Treasury rates. This would slow the pace at which agency repayments increased.

Though the power marketing administrations have promoted regional industrial bases by providing electricity to undeveloped areas, critics contend that the electricity prices charged today by the various agencies do not reflect the actual cost of delivering power. They point out that the original development goal has been met, and that the below-market rates simply represent an inequitable subsidy to certain regions--a cost borne by all taxpayers. Finally, they argue that withdrawing the subsidy from the power agencies' interest payments would not disrupt local economic activity, since electricity prices in areas served by the power agencies would still remain below the national average (they now are less than one-half of the national average). Proponents of the status quo counter that withdrawal of the subsidy could, for some industries, translate into higher product prices and lost market shares.

NDD-16 TRANSFER CONTROL AND FINANCING OF WATER RESOURCES AND TRANSPORTATION PROGRAMS TO USERS AND LOCAL AUTHORITIES

Savings from CBO Baseline		Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Total Function 400							
Budget Authority		4,990	5,175	5,225	5,380	5,485	26,255
Outlays		3,675	4,580	4,995	5,160	5,255	23,665
Total Function 300							
Budget Authority		1,000	1,100	1,100	1,100	1,100	5,400
Outlays		700	1,000	1,100	1,100	1,100	5,000
By Program							
Airways	BA	2,100	2,150	2,200	2,250	2,250	10,950
	O	2,150	2,150	2,200	2,250	2,250	11,000
Waterways	BA	600	700	700	700	700	3,400
	O	400	600	700	700	700	3,100
Amtrak	BA	60	65	65	70	75	335
	O	55	60	65	70	75	325
Transit	BA	880	880	880	880	880	4,400
	O	660	830	880	880	880	4,130
Highways	BA	1,500	1,600	1,600	1,700	1,800	8,200
	O	200	800	1,100	1,200	1,300	4,600
Ports	BA	800	800	800	800	800	4,000
	O	600	800	800	800	800	3,800
Shipping	BA	250	280	280	280	280	1,370
	O	510	540	550	560	550	2,710

NOTES: While transportation-related programs are spread across numerous budget categories, they are principally accounted for in budget functions 400 and 300. Function 400 includes programs for airways, Amtrak, transit, highways, Coast Guard (included in Ports), and merchant marine fleets and operations (included in Shipping). Function 300 includes programs for inland waterways and for channel and harbor maintenance (included in Ports). Cargo preference savings of $200 million annually in both budget authority and outlays are included in Shipping but are not included in the totals for either function 300 or 400, since these savings accrue across numerous functions and agency budgets.

Federal transportation expenditures provide significant opportunities for producing budgetary savings and for simultaneously improving the efficiency and efficacy of transportation programs. By transferring control over both financing and spending for many of these programs to nonfederal agencies, the federal subsidies for them could be reduced or eliminated, and the investment in transportation systems could be more closely matched to the demands of the systems' users.

This proposal consists of seven specific program changes that could be made independently or together:

- Transfer most responsibilities of the Federal Aviation Administration to a private corporation. This airways authority would have responsibility for the operation, maintenance, planning, and financing of the air traffic control system. Research and development programs and safety would remain federal responsibilities and be funded by current aviation taxes and fees.

- Transfer the inland waterway system to a private corporation, which would be responsible for operating, maintaining, planning, constructing, and financing locks and dams on inland waterways.

- Reduce operating subsidies for the National Railroad Passenger Corporation (Amtrak) by 10 percent from current levels.

- Eliminate federal operating assistance for mass transit systems.

- Eliminate federal funding of secondary and urban roads and local bridges. Interstate and primary system roads and bridges would remain federal programs and be funded by current taxes and fees.

- Require local contracting for and financing of some ocean and port services, including the operation and maintenance of aids to navigation, and dredging and maintenance of channels and harbors.

- Eliminate cargo preference for nonmilitary shipments, and eliminate the operating differential and ocean freight differential subsidies.

Eliminating federal financing and control of these programs could yield the following general benefits. First, private financing would require full recovery of costs from the programs' users and beneficiaries. Incentives

would therefore be present to minimize the costs of the services and to charge those costs to the users responsible for them or capable of paying for them. Second, physical capacity, investment, and the level of operation of each of these programs would be more closely matched to the demands of the users and their willingness to finance them. Finally, the establishment and enforcement of safety regulations in these programs would be further separated from the promotion and operation of transportation systems. The intent of these budgetary changes is not to eliminate the programs but to reduce or eliminate federal funding of them.

On the other hand, supporters of the current structure of these programs point out that the benefits provided by these programs, if only indirectly, are nationwide in scope; therefore, a federal role in their funding and planning is required and appropriate. Further, since many of the transportation services covered by these programs are currently provided by or would most efficiently be provided by a single supplier, there would be incentives for private firms to monopolize and try to gain private benefits at the expense of users of the systems. This might result in reduced services, higher than appropriate prices, or cross-subsidies. Efforts to avoid the abuse of monopoly power might require federal economic regulation in lieu of federal financing. Finally, along with federal funding and control of these programs comes federal expertise in managing them, which may be inefficient to duplicate or unavailable locally.

The current level of spending and a discussion of the specific reductions in these individual programs follows. These budgetary savings include only the elimination of annual subsidies, since receipts from the sales of assets were not estimated. In addition, secondary effects, such as increases in federal regulatory costs resulting from these program changes, were not estimated. Finally, in many of these programs, current federal taxes and fees would probably be reexamined if the program responsibilities were divested to other authorities.

Airways. In 1986, the federal government spent over $4.6 billion on air transportation programs, 50 percent of which was nominally funded by the 8 percent tax on airline passenger tickets and by aviation fuel taxes for private aircraft. Eliminating federal control and funding of the air traffic control system (ATC) would reduce federal spending by about $2.2 billion each year and by $11 billion through 1992. This estimate assumes that aviation taxes and fees are reduced by approximately $700 million annually, which is the current amount of ATC funding coming from these aviation trust fund sources. If these tax levels were not reduced, then the budgetary savings would be higher. If significant tax-exempt bonding were used as a

result of the creation of a private airway authority, the annual savings would be lower.

Waterways. Current federal spending to construct, operate, and maintain the locks and dams of the inland waterway system totals $600 million annually, a small portion of which is recovered through the current barge tax that is earmarked for new capital projects. Budgetary savings of $3.1 billion over five years would be reduced to the extent that tax reductions and bonding authority accompany transfer legislation. Appropriate pricing of waterway services may permit the reduction of what seems to be overcapacity in the inland system. On the other hand, it may be difficult to structure a private, user-owned corporation that can appropriately and efficiently price the use of the system given the number of competing interests involved.

Amtrak. The current annual subsidy for Amtrak amounts to just over $600 million. Reducing this subsidy would increase incentives for Amtrak to control its costs and to price its services efficiently. If not compensated for by local funds or fare increases, however, reducing the subsidy could force both a reduction in service and the payment of labor protection payments that could either offset some of the budgetary savings or threaten Amtrak's survival as an ongoing concern. A 10 percent reduction should not threaten Amtrak's survival and would maintain pressure on Amtrak management to price and operate efficiently. This reduction would reduce outlays by $325 million over the next five years.

Transit. Operating assistance for mass transit amounts to nearly $900 million a year. Operating assistance is a passenger subsidy whose requirement arises from local decisions on service levels that are either too great or on fare levels that are too low for revenues to fully cover operating costs; local responsibility for funding this passenger subsidy should assure that these fare and service decisions are made in an efficient and cost-effective manner. Total five-year outlay savings would be $4.1 billion.

Highways. Federal aid to secondary and urban roads and local bridges currently amounts to approximately $1.5 billion annually. By eliminating these programs from federal aid, local decisions on roadway investments will more closely match industrial, commercial, and residential demand for highway improvements, and outlays would be reduced by $4.6 billion through 1992. Since total highway authorizations persistently exceed obligation limits, obligation ceilings would have to be reduced by the amount attributable to obligations for secondary and urban roads. Otherwise, budgetary

savings would disappear, since increases in obligations for interstate and primary highways would replace these local obligations.

Ports. Ocean and port programs are provided by both the Coast Guard and the Army Corps of Engineers. The Coast Guard spends nearly $400 million annually to operate and maintain aids to navigation, while the Corps spends over $400 million each year to dredge and maintain channels and harbors; both services are of principal benefit to private commercial interests. By eliminating federal support for these services and requiring ports and local authorities to contract for and finance them, those individuals and organizations using and paying for the services would have a more direct voice in determining the level of services provided and their cost. User fees under the Omnibus Water Resources Development Act of 1986 are projected to recover only 40 percent of port costs. In addition, less than 1 percent of Coast Guard costs are recovered by user fees. This proposal would leave safety and enforcement activities with the Coast Guard, and would permit both the Corps and the Coast Guard to compete with private interests to perform the contract services. Five-year savings would total $3.8 billion.

Shipping. Current federal regulations require that U.S.-flag vessels carry one-half of government, nonmilitary, ocean freight shipments (as well as all such military shipments). This "cargo preference" requirement costs $200 million each year in federal subsidies. In addition, over $300 million each year is expended for the operating differential subsidy (ODS) and ocean freight differential subsidy (OFDS) programs. The ODS compensates U.S. operators of U.S.-flag vessels in foreign commerce for the differences between the operating costs of a U.S.-flag ship with an American crew and those costs of the foreign-flag competition. The OFDS specifically funds the additional cost for the shipment of government agricultural commodities that results from the 75 percent cargo preference requirements for these commodities versus the 50 percent requirement for other nonmilitary shipments. Some analysts contend that national security would be jeopardized by eliminating these programs because doing so would reduce government support for the U.S. merchant marine and its standby, military sealift capability. However, the shipping vessels that benefit from these subsidies are increasingly bulk vessels that are not easily adapted for military transport. Eliminating these subsidies would save $2.7 billion through 1992.

NDD-17 ELIMINATE FUNDING FOR UNTARGETED ELEMENTARY AND SECONDARY EDUCATION PROGRAMS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Eliminate Chapter 2 Block Grant						
Budget Authority	560	590	620	660	690	3,110
Outlays	45	430	580	620	650	2,320
Eliminate Untargeted Portion of Vocational Education						
Budget Authority	430	450	480	500	530	2,390
Outlays	10	340	450	470	500	1,770
Eliminate Mathematics and Science Education						
Budget Authority	85	90	95	100	100	470
Outlays	5	55	85	90	95	340

Most federal aid for elementary and secondary education is targeted toward students with special needs. Compensatory education (Chapter 1) funds, for example, are intended for low-achieving children in schools with many poor children. (Chapter 1 is part of the Education Consolidation and Improvement Act, or ECIA.) Federal funds also are provided to help educate handicapped children.

Substantial amounts of money, however, are spent on programs that have no federal requirement for targeting funds toward students with special needs. Examples are the Chapter 2 block grant (of the ECIA), the portion of vocational education grants not targeted toward specific groups of students, and the mathematics and science education program. Ending funding for these three areas would reduce budget authority by about $1.1 billion in 1988--$560 million from the block grant, $430 million from the untargeted portion of vocational education, and $85 million from the mathematics and science program. Outlays would be reduced by $60 million in 1988 and $4.4 billion over the 1988-1992 period.

These changes would save substantial amounts of federal money while leaving intact federal aid specifically directed to students and school districts most in need of that assistance. The effect on total spending for elementary and secondary education would also be small, because the reductions would constitute substantially less than 1 percent of total state, local, and federal expenditures. Moreover, since an unknown portion of these grants is used to support activities that districts would undertake even without the grants, eliminating these funds would have a smaller effect on the specific activities ostensibly funded by them than the size of the grant might suggest.

On the other hand, this reduction could pose hardships for some jurisdictions, because it would come at a time of increasing enrollments. Moreover, these programs have purposes other than increasing services to students with special needs. For example, Chapter 2 block grant funds are intended to provide districts with relatively unrestricted funds for program innovations and improvements, and one goal of the program innovation portion of the vocational education program is to help districts alter their training programs as the skills needed for employment change. Terminating federal funds would require districts to rely on state and local resources for these purposes; to the extent that the grants lead jurisdictions to provide services that they otherwise would not, these goals would be less well met.

NDD-18 REDUCE CAMPUS-BASED STUDENT AID

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Budget Authority	250	270	280	300	310	1,400
Outlays	25	240	270	250	300	1,080

The federal government provides campus-based student aid through three programs: College Work-Study (CW-S), National Direct Student Loans (NDSLs), and Supplemental Educational Opportunity Grants (SEOGs). Financial aid administrators at colleges and universities determine which eligible students receive aid. In the 1985-1986 school year, the federal government provided more than $1 billion of campus-based aid to more than 1 million students. Reducing federal funding for these programs by 20 percent would lower budget authority by $1.4 billion and outlays by $1.1 billion during the 1988-1992 period.

This option could be implemented by simply cutting federal appropriations, or the cut could be combined with a restructuring of the campus-based programs. The number and types of students affected would depend on how the cuts are structured and on how institutions and financial aid administrators react to the changes. Some institutions would continue their own student aid at existing funding levels, thereby having less financial aid available for students; other institutions might increase their own aid to offset part or all of the reductions in federal support.

Combining reduced funding with a restructuring of the campus-based programs could mitigate the effects of less aid. For example, the Congress could limit student eligibility. Because campus-based aid is not heavily targeted toward the lowest-income students, such changes would limit the adverse impact on the poorer students. On the other hand, such restrictions would reduce institutional discretion to adjust for students' special circumstances. A second option would consolidate the three campus-based programs into one block grant, thereby increasing administrators' discretion in allocating funds. Such an increase in discretion would probably not offset fully the effects of reduced funding, however, and could mean that federal goals were less well met. A third alternative would require institutions to provide a larger match of their own funds for each dollar received from the

federal government. If institutions provide the increased match by raising their own support for student aid, federal spending could be cut while maintaining the amount of assistance available to students. To the extent that institutions do not offset the reduction in federal spending, however, less student assistance would be available.

NDD-19 ELIMINATE OR RESTRICT ELIGIBILITY FOR COMMUNITY DEVELOPMENT BLOCK GRANTS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Terminate CDBG						
Budget Authority	3,100	3,250	3,350	3,500	3,650	16,850
Outlays	60	1,250	2,900	3,300	3,400	10,900
Restrict Eligibility and Reduce Funding						
Budget Authority	430	450	460	480	500	2,320
Outlays	10	170	400	450	470	1,500

The Community Development Block Grant (CDBG) program provides annual grants, by formula, to all metropolitan cities and urban counties under its entitlement component. The program also allocates funds to each state, by formula, for distribution through a competitive process among nonentitlement areas, which are generally units of local government under 50,000 in population that are not metropolitan cities or part of an urban county. The grants may be used for a wide range of community development activities, including rehabilitation of housing, improvement of infrastructure, and economic development.

For 1987, appropriations for the CDBG program amount to $3 billion, of which about $2.1 billion is allocated to metropolitan cities and urban counties and about $0.9 billion to nonentitlement government units. Substantial federal savings could be realized either by terminating the CDBG program or by restricting eligibility for the entitlement component to exclude the least needy communities while reducing funding levels.

Terminate CDBG. If the CDBG program were eliminated, federal outlay savings would amount to $60 million in 1988 and a total of $10.9 billion over the 1988-1992 period. Proponents of terminating the program contend that federal funds should be targeted toward programs that offer national benefits rather than to programs like CDBG that generate primarily local benefits and should therefore be funded by state and local governments. They

further suggest that, to the extent that localities use CDBG funds to compete against each other to attract business, benefits have been shifted away from localities to private firms.

On the other hand, opponents of terminating the CDBG program contend that many activities financed by the program are not generally undertaken by local governments--particularly the rehabilitation of low-income housing and, to some extent, economic development. Thus, eliminating this funding--the largest source of federal aid for many cities--would probably curtail these types of activities in many areas, and, in general, reduce resources benefiting low-income households. They further argue that CDBG funding has been figured into the budgets of all entitlement recipients; ending that support therefore could impose at least temporary stress on many governments, particularly in view of cutbacks in other federal assistance programs.

Restrict Eligibility and Reduce Funding for Entitlement Component. If the entitlement component were cut 20 percent by eliminating funding for the least needy communities, federal outlays could be reduced by $10 million in 1988 and $1.5 billion over the 1988-1992 period. Such a cutback would change the distribution between the entitlement and nonentitlement components from 70 percent-30 percent to 65 percent-35 percent. The entitlement component of the CDBG program now provides aid regardless of need, although jurisdictions with scarce resources receive larger grants than other communities. Proponents of this option contend that no pressing interest is served by supporting jurisdictions that have above-average ability to fund projects themselves. Eliminating funding for such communities rather than reducing grants across the board would ensure that the most distressed jurisdictions would retain the same level of aid.

On the other hand, CDBG funds in general must be used to aid low- and moderate-income households, to eliminate slums and blight, or to meet emergency needs. Thus, critics of this option argue that a reduction in federal funds for affluent communities would probably curtail such activities in pockets of poverty in those areas.

NDD-20 END FUNDING OF THE ECONOMIC DEVELOPMENT ADMINISTRATION AND URBAN DEVELOPMENT ACTION GRANTS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Terminate EDA						
Budget Authority	230	240	250	260	270	1,240
Outlays	25	100	170	220	240	760
Terminate UDAG						
Budget Authority	230	240	250	260	270	1,260
Outlays	10	60	120	180	250	620

The Economic Development Administration (EDA) provides grants to state and local governments for public works, technical assistance, and job programs, as well as loan guarantees and direct loans to firms for business development. In 1987, appropriations for EDA programs totaled about $215 million. The Urban Development Action Grant (UDAG) program, administered by the Department of Housing and Urban Development, received $225 million in appropriations in 1987 for distribution to local governments through a competitive selection process to help them finance economic revitalization projects. Federal spending for local economic development could be reduced by $35 million in 1988 and $1.4 billion over the 1988-1992 period by disbanding the EDA and eliminating the UDAG program as of 1988.

Some critics of these programs contend that federal assistance should not be provided for activities whose benefits are primarily local and which, therefore, should be the responsibility of state and local governments. In addition, both programs have been criticized for the types of projects that they fund, for allowing federal dollars to be used for projects that would have been supported anyway, for not directing funds to the most distressed areas, for substituting public for private credit, and for facilitating relocation of businesses from one distressed area to another through competition among communities for federal funds. In particular, EDA has been criticized for its broad eligibility criteria, which qualify areas containing 80 per-

cent of the U.S. population, and for providing aid with little proven effect at great expense compared with other programs with similar goals. While the UDAG program has more stringent eligibility standards and more evidence exists that completed projects are meeting investment and employment expectations, grants are often provided for projects in vital commercial centers where full conventional financing may have been available. Proponents of this option further argue that, because of the competitive nature of both programs, local governments would not have incorporated this type of aid into their budget plans and, thus, eliminating future funding of EDA and UDAG would not impose unexpected hardships on communities.

On the other hand, the reduction in aid associated with this option would curtail economic development activities in some financially distressed communities that might not be able to tap other resources. This could result in deterioration of infrastructure, loss of prospective jobs, and decreases in local tax receipts. Eliminating these two sources of funds might have especially serious consequences for the most distressed communities, particularly in view of overall federal cutbacks in urban aid programs.

NDD-21 CANCEL THE NASA INTERNATIONAL SPACE STATION PROGRAM

	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1988	1989	1990	1991	1992	
Savings from CBO Baseline						
Budget Authority	430	450	480	500	530	2,390
Outlays	230	410	460	490	510	2,100
Savings from Administration's Request						
Budget Authority	770	1,840	2,000	2,200	2,140	8,950
Outlays	410	1,290	1,850	2,100	2,150	7,800

The National Aeronautics and Space Administration (NASA) is in the planning and design phase of a program to build an international space station. The facility will cost (in 1984 dollars) an estimated $11 billion, of which the United States will provide $8 billion and European, Canadian, and Japanese partners the remaining $3 billion. The permanently manned station is to be operational in 1993. It will provide infrastructure to support scientific and commercial activity and a departure point for future manned and unmanned exploration of the solar system.

Canceling the current space station program without initiating an alternative could save as much as $2.4 billion in budget authority relative to the CBO baseline and as much as $9 billion relative to the Administration's request. Savings relative to the CBO baseline are lower because the baseline projects no real growth above 1987 appropriations for planning the space station, while the Administration's request includes real growth for procurement and construction of the space station. Because many of the current program's objectives are desirable, an alternative to cancellation is a more modest program using intermittently tended and unmanned facilities rather than a permanently manned facility. Pursuing such an alternative would almost certainly increase expenditures relative to the CBO baseline, but could realize savings relative to the Administration's request. Further study is necessary to determine the cost of this type of option.

In support of canceling the current space station program is the lack of compelling arguments to undertake the project in light of the traditional objectives of U.S. space policy. No significant purpose of national security will be served, as the Department of Defense has expressed very limited interest in using the NASA station. Many civilian scientific goals could be met earlier and at a lower cost with a more modest program. Some scientists argue that the space station will absorb funds that would be better spent on space science and exploration, where the known returns are greater. National prestige would be enhanced by having a space station, yet the current plan would create a permanently manned facility eight years after the Soviet space station, which was launched in 1986.

More specific arguments to support cancellation of the space station focus on the program's diminishing ability to stay within the $8 billion budget. Additional doubts have been raised about NASA's ability to conclude agreements with the international partners on division of facilities and operating costs that serve U.S. interests. Finally, the launch demands of the space station during the two years of construction would require up to 80 percent of the available shuttle flights and might force launch delays on projects with more definite benefits.

The arguments for the current space station program emphasize its possibilities, both known and unknown, and the U.S. commitments to its allies. The prospects of known uses such as organic and inorganic materials research and, ultimately, manufacturing may be sufficient to justify continuing the program at some level. Advocates further contend that other significant uses for a space station will be discovered after it is operational. From the perspective of national security and foreign policy, if the United States were to back out of the current program, Europe, Canada, and Japan would be driven to continue the project on their own or perhaps in cooperation with the Soviet Union.

NDD-22 CANCEL FUNDING FOR A SPACE SHUTTLE TO REPLACE THE CHALLENGER

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Budget Authority	0	0	0	0	0	0
Outlays	220	600	620	450	150	2,040

The National Aeronautics and Space Administration (NASA) has received funding to replace the space shuttle Challenger, which was lost in an accident on January 28, 1986, and return the shuttle fleet to its preaccident level of four orbiters. At the same time, current policy has reduced the role of the shuttle system from primary U.S. launch vehicle to a status equal to various expendable launch vehicles (ELVs).

To create a balanced national launch capacity, the Department of Defense is buying two new types of ELVs and refurbishing a third, ensuring an annual capacity equivalent to 12 shuttle flights a year by 1990. If the three orbiters in the shuttle fleet can provide an additional 9 to 12 flights a year, the total annual U.S. launch capacity will be 21 to 24 equivalent shuttle flights by 1990. Canceling the procurement of a new orbiter would save $2 billion through 1992, but would deprive the shuttle system of an additional three or four flights' worth of capacity through the 1990s.

Proponents of canceling procurement of the orbiter claim that a new orbiter would be underused during the 1990s. If so, the near-term expenditures to buy an orbiter would not be justified by the later savings of operating a fourth orbiter rather than using additional ELVs to meet launch demand. Large increases in the demand for space launches are projected for the late 1980s and through the 1990s. However, the projected demand for space launches has consistently exceeded actual demand, and current projections may not be realized. The loss of the Challenger further reduces launch demand by diverting public funds from payload development to fixing the shuttle system and by increasing the cost of space transportation in general. These factors reduce the annual demand for space launches to a level that can be met by the existing three orbiters and the ELVs.

Advocates of purchasing an additional orbiter offer several arguments to support their view. They maintain that future launch demand will require a replacement orbiter to make an average of four flights a year during the 1990s, making an orbiter less costly than comparable ELV service. The current plan of the space station (see NDD-21) to use only orbiters in building and resupplying the space station also supports a replacement orbiter. Implementing this plan would leave very little shuttle capacity for military or other civilian use if the fleet is restricted to three orbiters. Proponents also point to the value of increasing the capacity of the shuttle system to assure access to space in the event that another orbiter is lost or grounded for a prolonged period. Finally, they point out that the current procurement represents the last chance to buy an orbiter because production lines will be permanently shut down if the orbiter is canceled.

NDD-23 ELIMINATE PURCHASES FOR THE STRATEGIC PETROLEUM RESERVE

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1988	1989	1990	1991	1992	
Budget Authority	430	470	530	500	530	2,460
Outlays	330	460	510	520	520	2,340

The Department of Energy (DOE) is responsible for the construction and maintenance of the Strategic Petroleum Reserve (SPR) and for the acquisition of oil to fill the reserve. Scaling back planned capital improvements and imposing a moratorium on further oil purchases could save up to $2.3 billion over the 1988-1992 period.

The original intent of the SPR, authorized in 1975, was to mitigate the economic problems that can result from full or partial interruption of oil imports to the United States. It therefore functions as an economic "insurance policy" that could help maintain U.S. output in the event of a severe oil shortage. The SPR will contain roughly 530 million barrels of crude oil by the end of 1987, with 750 million barrels being the eventual goal. Additional unobligated balances of funds for oil purchases would allow DOE to fill the reserve to a level of approximately 540 million barrels. At that level, the SPR could meet current U.S. demand for oil imports for roughly 100 days (about 35 days of total U.S. demand). Today, the U.S. economy depends less on imported petroleum than it did in the late 1970s, and oil supplies are abundant and available from various sources. In fact, a reserve of 750 million barrels would have covered fewer than 100 days of demand during the peak years of oil imports, 1977 through 1979.

In light of these shifts in the oil market, further purchases for the SPR could be suspended, saving approximately $2.2 billion in outlays over the 1988-1992 period. In addition, planned improvements to the physical plant and distribution system could be eliminated, saving $170 million over the five-year period.

Although the current status of energy markets may reduce the need for a larger reserve (and low oil prices reduce the market value of the

current reserve), low oil prices also make filling the SPR cheaper, and therefore present an opportunity to achieve the original target at lower cost. In addition, the SPR can be thought of as a public asset; continuing to fill it may represent an attractive investment should oil prices increase in the near future.

NDD-24 MODIFY THE DAVIS-BACON ACT BY RAISING THE CONTRACT THRESHOLD AND ALLOWING UNRESTRICTED USE OF HELPERS

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Budget Authority	640	660	680	710	740	3,430
Outlays	140	390	530	590	640	2,290

Since 1935 the Davis-Bacon Act has required that "prevailing wages" be paid on all federally funded or assisted construction projects of $2,000 or more. Procedures for determining prevailing wages in the construction area, and the classifications of workers receiving them, in some cases favor union wage rates, although recent changes in regulations have lessened this effect. The act also restricts use of lower-wage, less-skilled workers such as helpers. Under current regulations, wages for helpers are usually not determined separately, with the result that most workers on covered projects are paid journeymen's wages.

Federal outlays for construction could be reduced by raising the threshold for determining projects to be covered by Davis-Bacon, by allowing unrestricted use of helpers, or by doing both. The specific option depicted in the table would raise the threshold from $2,000 to $250,000 and allow unrestricted use of helpers. These measures would reduce outlays by about $140 million in 1988 and by about $2.3 billion over the 1988-1992 period. Most of the savings would result from the increased use of helpers; allowing their unrestricted use, while not changing the threshold, would reduce outlays by about $2.1 billion over this five-year period. (Allowing unrestricted use of helpers and raising the threshold to $25,000 or to $1 million would reduce outlays over this five-year period by about $2.2 billion, or $2.6 billion, respectively.)

Proponents of relaxing Davis-Bacon standards contend that the act artificially drives up the cost of federal construction projects. Besides reducing outlays for construction, unrestricted use of helpers probably would increase employment opportunities for less-skilled workers on federal projects. Raising the threshold to $250,000 would exclude about 7 percent of

the value of all contracts currently covered by the act. (Setting the threshold at $25,000 would exclude only 1 percent, and setting it at $1 million would exclude about 20 percent.)

Opponents of modifying the act contend that such changes would lower the wages of construction workers. They also argue that relaxing Davis-Bacon standards could jeopardize the quality of federally funded or assisted construction projects.

FEDERAL WORK FORCE

The equivalent of 5.4 million full-time civilian and military employees now work for the federal government. Outlays in 1987 to pay these employees and to cover benefit disbursements, including those for former employees and their families, will total about $186 billion (see Table II-3). Pay for postal employees, which is mainly determined through collective bargaining, accounts for approximately $22 billion of this amount. The $164 billion remaining represents 16 percent of total budget outlays and is subject to periodic Congressional review. Under CBO's baseline, five-year spending for pay (excluding that of postal workers) and for fringe benefits is projected to increase nearly $135 billion through 1992. This projection assumes that nonpostal employment remains at its current level. More than four-fifths of the additional compensation outlays is attributable both to pay adjustments that are assumed to keep pace with raises in the private sector ($69 billion) and to greater disbursements for federal civilian and military retirement ($44 billion). The growth in retirement outlays derives mainly from increases in the number of annuitants, larger initial annuities because of higher career earnings, and postretirement cost-of-living adjustments (COLAs).

In carrying out its budgetary and appropriation responsibilities, the Congress makes decisions on a wide array of program activities that make up the federal budget. Such programmatic decisions, of course, affect the total level of federal personnel resources required in future years. (For example, see option DEF-18 in the National Defense section of this report and option NDD-16 in the Nondefense Discretionary Spending section.) The Congress also considers various measures specifically aimed at changing the size of the work force or the compensation it receives. The opportunities for achieving further budgetary reductions, however, diminish because of measures already taken. Recent Congressional actions, outlined below, reflect responses to often competing national priorities--meeting federal program requirements in defense and nondefense areas, seeking fair treatment of federal workers and retirees, assuring a qualified federal work force, and helping to reduce federal spending.

Size of the Work Force. In recent years, federal civilian employment in nonpostal agencies has held steady at about 2.2 million. Reductions for nondefense agencies have offset increases at the Department of Defense (DoD). Since 1980, DoD has hired the equivalent of 160,000 full-time civilian workers. (Postal employment, which is independent of the job ceilings used at other agencies, has increased rapidly in the last year in response to the growing workload.) The Administration's efforts to expand contracting out and to dismantle selected agencies would reduce federal employment, but the Congress has resisted such efforts. In addition, some agencies, such as the Internal Revenue Service and the Customs Service, were authorized to add many more jobs than the President requested.

TABLE II-3. FEDERAL WORK FORCE AND COMPENSATION: FISCAL YEAR 1987

Personnel	Total Employment a/ (In thousands)	Payout Costs (In billions of dollars) b/ Payroll	Retirement and Other Benefits	Total
Nonpostal				
Uniformed military	2,434	37.6	30.8	68.4
Civilian	2,200	60.2	28.1	88.3
Subtotal	4,634	97.8	58.9	156.7
Postal Service	805	22.1	7.0	29.1
Total	5,439	119.9	65.9	185.8

SOURCE: Congressional Budget Office.

a. Estimates of the work force represent the equivalent of full-time employment under a regular 40-hour week. On this basis, estimates of uniformed military personnel include active duty, reserve, and national guard forces for both civilian and defense agencies.

b. Amounts represent gross disbursements to current employees, federal retirees, and their survivors. Payouts to this group from Social Security trust funds are excluded because they cannot be identified.

Pay Raises for Active Workers. Continuing past practice of restraining the size and timing of annual pay raises, the Congress delayed for three months the 1987 pay raise for all workers and capped it at 3 percent. (The President had proposed an across-the-board increase of 2 percent with a three-month delay for civilian workers, and a 4 percent military adjustment, without delay, effective October 1986.) The limitations were adopted mainly to aid budgetary objectives, despite proposals to make greater use of basing pay on performance and despite indications that federal salary levels remain well below pay rates for comparable private-sector jobs.

Cost-of-Living Increases for Current Federal Retirees. The Congress enacted legislation that protects future COLAs for federal retirees from being suspended under provisions of the Balanced Budget Act. The 1986 sequester mechanism, by contrast, eliminated that year's COLAs for military and civilian annuitants while benefits for Social Security recipients were allowed to increase by 3.1 percent.

Benefits for Future Retirees. Last year the Congress enacted major reforms in the military and civilian retirement systems (Public Laws 99-348 and 99-335). Initial benefits are reduced for future military employees who retire after 20 years of service, and for civilian annuitants retiring with less than 20 years of service and before age 62. The retirement package available to new civilian workers (as well as tenured workers electing to switch systems) includes Social Security coverage, a pension with defined but less generous benefits, and a voluntary thrift savings plan that includes employer matching contributions. In addition, unused sick leave is excluded when calculating initial benefits, the benefit subsidy for surviving spouses is tightened, and--most significant--COLAs are eliminated for nondisabled retirees before age 62. Overall, the three-tier combination of benefits for newly hired federal civilian employees reduces the government's actuarial costs for retirement by the equivalent of 3 percent of pay.

If the major pay and retirement actions noted above had not been taken by the Congress, the federal budget deficit projected by the CBO baseline would have been $2.6 billion higher in 1988. In addition to the immediate deficit reduction, the government will realize significant long-term savings that derive mainly from retirement reforms. Despite these cutbacks in compensation, the size and associated costs of the federal work force still offer potential for additional near-term savings.

This section presents five options for reducing the government's costs for travel and for federal employee compensation--mainly pay and retirement benefits. The first option would alter the timing and distribution of across-the-board federal pay raises. FWF-02 addresses the outlay savings

that would result from restricting the payment of cost-of-living adjustments for nondisabled federal retirees under age 62. The next two options, FWF-03 and FWF-04, would reduce the costs of the Federal Employees Health Benefit Program and limit travel expenses. The final option would trim the size of the federal civilian work force without necessarily affecting federal services.

FWF-01 ALTER THE TIMING AND DISTRIBUTION OF FEDERAL PAY RAISES

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Budget Authority	590	1,250	1,450	1,700	1,750	6,740
Outlays	610	1,300	1,500	1,700	1,750	6,860

Changing the timing and the distribution of government pay raises could generate appreciable savings in the cost of federal pay. Savings would accumulate to about $6.9 billion through 1992 if across-the-board yearly adjustments for military and civilian employees were delayed three months beginning in 1989, and if the basic payroll for most white-collar employees was permanently lowered by cutting two percentage points from the 3 percent across-the-board raise estimated for 1988. These savings would produce a permanent source of funds from which annual bonuses would be paid. Thus, some deserving employees could receive more compensation, after the first year, than permitted under current law. To realize budgetary savings in 1988, bonus payments would not begin until 1989. The bonuses would augment future across-the-board adjustments, which CBO assumes reflect private-sector pay raises. The agencies would distribute the bonuses in accordance with governmentwide criteria pertaining to performance and to recruitment and retention requirements.

Federal employees and their representatives would criticize this option because it would not narrow the gap between federal and private salaries for white-collar employees, now estimated at more than 20 percent. (Instead, the proposal actually widens the gap for many employees because a higher level of permanent pay for all workers is traded for only the prospect that some deserving employees might receive a bonus.) Only once during the past 11 years have the federal government's 1.6 million white-collar employees received an annual pay raise both at the normal time and at the levels prescribed under current law as necessary to make their pay comparable with private-sector rates for comparable jobs. The successive limitations on pay increases, culminating in a 1986 freeze on across-the-board adjustments, have been adopted mainly to reduce the budgetary costs of government operations. As a result of past austerity, today's salaries for federal jobs lag significantly behind estimated pay levels for similar work in the private sector--especially for professional and administrative positions.

While many question the accuracy of comparisons of salary levels, the rate of change in private-sector pay as measured by the Employment Cost Index indicates that federal salary adjustments have not kept pace. In the six years ending December 1986, the total increase in federal pay rates for most white-collar positions was 17 percent. The rise in private salaries and wages during this period was more than twice as large, and the cumulative adjustment in military pay was 32 percent. As a result, critics maintain the government has lost some of its most talented civilian workers and is unable to compete in hiring and retaining well-qualified college graduates. This option, they believe, would add to such problems.

Proponents of the option respond by pointing out that the pay of employees who consistently receive bonuses--because they occupy hard to fill positions or because of outstanding job performance--would actually be higher than under current law. Overall, the proposal would give agencies greater flexibility in rewarding outstanding workers and addressing recruitment and retention problems on a geographic and occupation-by-occupation basis. The use of bonuses to distribute pay is consistent with practices in some parts of the private sector and with measures taken by the federal government that emphasize case-by-case determinations rather than uniform across-the-board pay adjustments. Such measures include pay-for-performance demonstration projects at some agencies, merit pay plans for federal managers, and authority to pay above standard rates in certain situations. (The Administration's budget proposes to replace "within-grade" salary increases, which are usually granted automatically based on job tenure, with a pay-for-performance system.) In addition, maintaining a three-month delay for governmentwide pay raises would continue a precedent that first began in 1984 but ends in 1988 under current law. The delay, by itself, would generate outlay savings through 1992 of $6.2 billion--about 9 percent of what federal workers would otherwise receive.

FWF-02 CAP COST-OF-LIVING ADJUSTMENTS FOR FEDERAL RETIREES UNDER AGE 62

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Military Retirement	80	200	330	480	640	1,730
Civilian Retirement	30	60	90	130	170	480
Total	110	260	420	610	810	2,210

The Civil Service Retirement (CSR) and Military Retirement (MR) systems provide benefits for about 3.6 million people at an annual cost of $44 billion. About 55 percent of MR beneficiaries and 10 percent of CSR beneficiaries are nondisabled retirees under age 62. Benefit payments in 1987 for this relatively young group will exceed $14 billion. Cost-of-living adjustments (COLAs) for federal retirees that begin before age 62 are fully paid for by the government and are expensive relative to adjustments available under the largest and most generous private pension plans.

This option, a two-step approach, would cap the annual COLAs for nondisabled retirees under age 62 at one percentage point below the inflation rate as measured by the Consumer Price Index (CPI), and would grant a catch-up raise at age 62 to account for inflation since retirement. It would provide full COLAs after age 62. (Although the catch-up adjustment restores the monthly pension to what it otherwise would have been at age 62, the annuitant is never compensated for the smaller benefit payments received during the time COLAs were capped.) The COLA limitation would cause outlays through 1992 to fall by $2.2 billion--less than 1 percent of total outlays otherwise disbursed during the same period for the CSR and MR systems. About four-fifths of the losses would be taken by current retirees, and the rest by those retiring in the next five years.

Recently enacted military and civilian retirement reforms reduced the future cost of federal pensions for newly hired employees. The military system reforms curtail benefits for newly hired personnel by reducing most initial annuities and by capping COLAs at the rate of inflation less one percentage point (CPI-1%). But at age 62, in a manner consistent with this option, future military retirees will receive a catch-up adjustment that

restores the purchasing power lost since retirement. Nondisabled civilian retirees under the new system, on the other hand, will not receive any COLA until age 62, nor any catch-up raise for price increases since their retirement. For future civilian and military annuitants alike, COLAs awarded after age 62 are limited to CPI-1%. COLAs for individuals who remain covered by the old CSR and MR systems, by contrast, are unaffected and equal 100 percent of the CPI. (The President's budget proposes a CPI-1% COLA for CSR but not for MR annuitants.)

This option, if adopted, would moderate the differences between retirement benefits available to newly hired employees and those available to individuals covered by the CSR and MR systems. As such, it would reduce protection from inflation and thus real benefits for federal retirees of working age. The loss in retirement income would be especially pronounced for MR employees, who retire at an average age of 43. But at age 62 and beyond, COLAs for federal pensions would remain more generous, with the catch-up, than would the partial inflation protection for those receiving private pensions combined with Social Security. Less than half of the retirees in the private sector are covered, in addition to Social Security, by employer-provided pension plans. These individuals typically receive pension COLAs on an ad hoc basis, which eventually recover 30 percent to 40 percent of general price increases. Of course, Social Security COLAs are automatic and keep pace with inflation; but employees cannot draw Social Security retirement until after reaching age 62.

Because considerable planning and changes in personal affairs often precede decisions to retire, opponents of this option argue that changing the rules for people after they retire or for those close to retirement is unfair. Moreover, many would contend that federal workers traditionally have accepted a compensation package that provided superior pensions at the expense of lower pay. Further, some critics fear that future budgetary pressures may either erode the size of the proposed catch-up adjustment or delay it beyond age 62. In addition, CBO estimates that this option ultimately would diminish the number of military personnel with over four years of service, and would thus engender a slight shift to a less experienced and lower-skilled military force.

Proponents counter that in order to realize large deficit reductions, the Congress must consider alternative COLA provisions that generate considerable near-term savings. One possibility is to curtail adjustments for all nondisabled CSR, MR, and Social Security annuitants. (ENT-14 would restrict federal retirement and Social Security COLAs.) Other alternatives could pivot directly, or indirectly like this option, on the beneficiary's earnings capability. In general, financial hardships from smaller COLAs

would be more pronounced for disabled and survivor annuitants than for the relatively young retirees targeted by this option, who should be in a better position to face a temporary loss in real benefits. Presumably, these young retirees are able to supplement their federal pensions by working--as most military retirees already do.

FWF-03 MODIFY THE FEDERAL EMPLOYEES HEALTH BENEFITS PROGRAM

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Outlays	150	260	350	520	660	1,940

The Federal Employees Health Benefits (FEHB) program offers health insurance coverage for federal employees and annuitants (that is, retirees) and their dependents. In 1987, the program will cover 3.9 million enrollees at an annual premium cost to the federal government of about $3.5 billion. About half of this amount pays hospitals for services provided to FEHB enrollees.

Program costs could be reduced by reforming hospital reimbursement procedures. Most FEHB insurance carriers pay hospitals on a "reasonable" cost basis. An alternative reimbursement system could require carriers to use a prospective payment system similar to that now used by Medicare and by the Civilian Health and Medical Program of the Uniformed Services for military personnel. Under these programs, hospitals receive a flat payment per case based on a patient's diagnosis. Applying a similar reimbursement system to FEHB based on diagnosis-related groups (DRGs) would entail modifying the Medicare payment schedule to reflect the health care needs of younger patients. Any hospital that accepts federal reimbursement from Medicare could be required to accept the predetermined rate as payment for FEHB enrollees. A hospital would be prohibited from charging enrollees more than the DRG amount the carriers are required to pay.

Savings realized by FEHB insurance carriers under this prospective payment system would allow for lower premium payments by both enrollees and the federal government. The government's savings would reach $1.9 billion, or 7 percent over five years. Savings to employees could reach $1.3 billion over the same period. These estimates assume that annual increases in DRG reimbursements would be tied to the hospital price index. This index has grown at a much slower rate than FEHB insurance premiums, and the CBO baseline assumes this historical relationship will continue. Otherwise, a DRG system, by itself, would not necessarily save any money.

Advocates of bringing FEHB under a prospective payment system argue that hospitals would be less able to shift costs from Medicare to other third-party payers, like FEHB carriers, that currently reimburse without DRG limits. In addition, some proponents believe that an expanded DRG reimbursement system would also reinforce existing incentives for hospitals to contain costs. In their view, the current system drives up costs because hospitals tend to provide FEHB and other insured patients more amenities, more technology, and more staff than are necessary. A DRG system, by contrast, seeks to increase hospital efficiency while maintaining the quality of health care. Moreover, establishment of a DRG system for FEHB patients could help pave the way for all insurers to switch to a prospective payment plan.

Opponents of this proposal would voice many of the same concerns about jeopardizing the quality of health care that were raised during debate on adopting the DRG scheme for Medicare. Because the payment does not recognize costs actually incurred on behalf of each patient, hospitals would profit from cases where a patient was healthier than average and would suffer a financial loss when a patient was sicker than average. Under such economic incentives, opponents argue, some hospitals may avoid treating patients with severe illnesses, encourage profitable admissions of those with minor health problems who do not necessarily require hospitalization, or discharge some patients prematurely. Some critics are also concerned that, over time, DRG relative prices might diverge from costs, causing hospitals to accentuate the selection of patients on the basis of profit considerations. In addition, excessive costs might arise in setting up a DRG accounting system to serve the relatively small numbers of younger FEHB patients in many areas. Finally, in those areas with large numbers of federal workers and retirees, such as the Washington, D.C., metropolitan area, this option would concentrate the effects of lower FEHB payments on a relatively small number of hospitals.

FWF-04 REDUCE FEDERAL TRAVEL EXPENSES

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Budget Authority	600	640	670	710	740	3,360
Outlays	560	580	620	650	690	3,100

The Executive Branch currently spends about $6 billion a year on travel for civilian and military employees. Appropriation action requiring a 10 percent across-the-board cut in travel expenses would save, relative to the CBO baseline, $3.1 billion over five years. About 70 percent of this savings would arise from Department of Defense travel, 60 percent of which is dedicated to the permanent change of station (PCS) of uniformed personnel. The 1987 appropriation for PCS is about $2.5 billion, or about $200 million below that for 1986. But total federal travel outlays in 1987 probably will increase by $400 million, in part because of recently enacted legislation providing employees with higher reimbursement levels for lodging and per diem costs.

The General Services Administration and Department of Defense, which manage travel arrangements for civilian and military personnel, respectively, report that recent improvements in procurement methods have reduced government travel expenses. Despite these achievements, and despite across-the-board limits on the 1982 travel budget imposed by the Omnibus Reconciliation Act of 1981, as well as agency efforts to comply with the Deficit Reduction Act of 1984 by reducing travel as part of administrative expenses, the rise in governmentwide travel expenses appears unnecessarily high in relation to price increases. Federal travel costs per civilian employee increased by 41 percent between 1981 and 1986, while prices for travel services during the same period increased by only 33 percent. Although improvements implemented by agencies have prevented some unnecessary travel expenses, further changes in travel management or outright reductions in the amount of travel could produce additional savings.

Proponents argue that an across-the-board reduction in 1988 would prompt agencies to pursue cost-saving practices more aggressively. Such practices include better monitoring of costs, eliminating low-priority travel, and greater use of innovative procurement methods like negotiated discounts for high-volume travel, commercial charge cards, and travel offices.

On the other hand, enactment of a 10 percent reduction in travel expenses could create difficulties for programs that rely heavily on travel for effective management. Agencies with many field offices or contractors, for example, may face inefficiencies or added costs in other areas if required to make cuts in travel. Opponents of limiting travel point out that the risk of inefficiencies increases as possible management improvements and cuts in low-priority travel are exhausted. Furthermore, some substitutes for travel, such as purchasing telecommunications equipment, could result in higher near-term outlays. From this perspective, singling out travel is less preferable than a general reduction in administrative expenses, the approach taken in the Balanced Budget and Emergency Deficit Control Act of 1985. Finally, some critics argue that further limitations in military travel, which is largely PCS travel, would interfere with national defense activities. Savings from a travel cut could be offset by some additional costs as the number of trips home to the United States increases to compensate for extended overseas tours, and as recruiting requirements grow to balance the loss of personnel who do not reenlist because of extended tours. If military travel was exempted from the 10 percent reduction, however, the budgetary savings would greatly diminish.

FWF-05 TRIM THE SIZE OF THE FEDERAL CIVILIAN WORK FORCE

Savings from CBO Baseline	Annual Savings (millions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Budget Authority	--	710	1,500	2,400	3,350	7,960
Outlays	--	580	1,200	1,950	2,750	6,480

Appropriation and other action to trim the size of the federal work force, as contrasted to cuts in salaries and benefits, offers another way to reduce personnel costs. Eliminating the equivalent of 100,000 federal jobs through 1992 would reduce the civilian work force in nonpostal agencies by about 5 percent from its current level of 2.2 million and would generate outlay savings of $6.5 billion over five years. For estimating purposes, a job is the work done throughout a year on a full-time basis. (For another item that would affect the size of the civilian work force, see DEF-18.)

Given normal employee turnover, the employment reduction specified in this option could probably be achieved without layoffs. Moreover, if the reductions were accompanied by commensurate measures to improve the productivity of operations, the level and quality of services would remain about the same. In fact, productivity gains of only 1 percent a year through 1992 would permit elimination of just over 100,000 jobs while maintaining existing levels of service. Should the demand for services increase, of course, greater improvements would be required.

Most agencies should be able, with little difficulty, to achieve such a rate of improvement. According to most recent data from the Department of Labor for the five-year period 1981 through 1985, productivity for civilian nonpostal agencies has grown at an average annual rate of 2.2 percent. Indeed, some large civilian agencies faced with limitations on funding and personnel increased their productivity over three years by an average of 3.2 percent per year. At the Department of Defense (DoD), however, greater effort may be required to achieve 1 percent annual growth of productivity in view of recent trends. The DoD annual rate of improvement for work performed by civilian and military personnel averaged only 0.7 percent during the last five years.

Proponents argue that reductions in the work force, especially if accompanied by improvements in productivity, could foster improved operating procedures, more productive use of training programs, increased use of computers and other labor-saving equipment, and better agency management of human resources. Experience with cutbacks in nondefense programs reinforces such expectations. Requirements to cut the size of the work force might also encourage more far-reaching and often-proposed reforms, particularly at DoD. Such proposals, which usually entail high start-up costs, include restructuring major maintenance and supply activities, greater sharing of support services, closing or consolidating some facilities, and reorganizing the administration of defense contracts.

Opponents believe that using across-the-board reductions in employment in setting funding levels for agencies can be counterproductive. The goals themselves may not be realistic in view of the unique limitations and mission requirements of many activities, especially those relating to national security. Indeed, some observers believe that such goals would decrease the control and flexibility DoD managers need to maintain military readiness. Should agencies fail to find ways of improving productivity to compensate for employment cuts, the quality or level of services would decline. Other critics express concern about the uncertain costs of obtaining new equipment and of other measures to improve productivity. (The estimated savings presented in this option represent net amounts from the CBO baseline after allowing for substitution of capital investment for labor and other associated costs. For estimating purposes, such costs are assumed to be a one-time charge of 12 months' compensation for each workyear eliminated. Any additional implementation costs are assumed to be covered by reallocating existing funds.)

REVENUES

Federal revenues could be raised by changing existing taxes or by introducing new taxes such as a value-added tax or energy tax. This section presents 20 options for raising revenues from these sources. Revenues could also be raised by increasing taxpayer compliance with current law, as described below.

RAISING REVENUES FROM THE INCOME TAX

This year, options for changing the income tax must be evaluated in the context of the major revisions made by the Tax Reform Act of 1986 (Public Law 99-514, hereafter referred to as TRA). Before passage of TRA, an obvious way to raise revenues from the income tax was to curtail or eliminate tax preferences--the deductions, exclusions, and other provisions that reduce tax liability for selected taxpayers or activities. Most tax preferences reduced federal revenues significantly, and many were subject to challenge based on considerations of equity and efficiency.

TRA reduced the amount of revenue forgone because of tax preferences. It did this directly, by eliminating or limiting specific tax preferences ("base-broadening"). It also indirectly lowered the value of remaining tax preferences by reducing tax rates. The act also changed the distributional effects of some of the remaining tax preferences by targeting their benefits toward lower- and middle-income groups, contributing to the progressivity of the tax system. Finally, by reducing tax rates, the act also lessened the negative impact of tax preferences on the efficiency of the economy.

Many tax preferences remain, however. These include provisions that affect individuals, such as most itemized deductions and the exclusion from taxable income of employer-paid fringe benefits. A few preferences for businesses in specific industries also remain. Changes that could be made to current income-tax preferences are described in 14 of the revenue-raising options presented below.

TRA was designed to raise the same revenue from the income tax as under prior law, but it redistributes the tax burden. For many individuals,

TRA's base-broadening provisions are more than offset by rate reductions: total revenues from the individual income tax in 1988 will be about $27 billion less than under prior law. For many corporations, TRA's changes will result in increased taxes: corporate tax payments in 1988 will be about $25 billion greater than under current law. Thus, TRA will shift some of the burden of the income tax from individuals to corporations.

Some people argue that revenues should be raised without changing the current distribution of the tax burden between individuals and corporations. This could be done by raising income tax rates across the board. This method of raising revenues is preferred by those who consider the distributional effects of TRA to be fair. Opponents of across-the-board rate increases argue that corporate taxes should not be raised in addition to the increases made by TRA. They point out that corporate tax increases are eventually passed on to individuals through changes in the value of corporate shares, in dividends, in wages, or in product prices. They are also concerned that corporate tax increases may have adverse effects on the economy.

Another argument against raising tax rates is that it might create public pressure to reinstate many of the tax preferences that were curtailed by TRA. The act was a compromise predicated on balancing reduced tax preferences against lower tax rates. Legislators (and taxpayers) who accepted this tradeoff in TRA might object if the rate reductions were reversed without corresponding increases in tax preferences.

Arguments can be brought against changing the income tax at all, whether through base-broadening or through rate increases. TRA was the fourth major income tax bill since 1980, following the Economic Recovery Tax Act of 1981 (Public Law 97-34), the Tax Equity and Fiscal Responsibility Act of 1982 (Public Law 97-248), and the Deficit Reduction Act of 1984 (Public Law 98-369). Both the government and taxpayers bear costs whenever the tax code is changed. For example, the government must revise its tax forms and instructions, issue new regulations, retrain IRS staff members, and make new tax court rulings; and taxpayers and their advisors must familiarize themselves with the new code. Tax law changes also cause windfall gains and losses for many taxpayers to the extent that changes in tax preferences and marginal tax rates affect the value of assets.

INCREASING TAX COMPLIANCE AND ENFORCEMENT

Another way to raise revenues would be to increase compliance with current tax laws. The Internal Revenue Service (IRS) estimates that the revenue loss from noncompliance is significant: in 1987, about $100 billion in taxes

will go unpaid because of underreporting of income, overstatement of deductible expenses, failure to file, or failure to pay tax liabilities even when reported correctly. In addition to reducing federal revenues, noncompliance makes the distribution of the tax burden less equitable than the law intends, and gives those who fail to comply a competitive advantage in the economy.

On the other hand, increased enforcement has its costs. These include the costs of additional personnel and equipment, which must be diverted from other productive activities, and the costs to taxpayers who are already complying but may have to spend more of their time justifying their returns. Taxpayers may also view additional enforcement activities as government harassment and an invasion of privacy, which could reduce compliance over the long run. Some of the additional costs may be difficult to quantify, but they should be taken into account when deciding to increase enforcement.1/

Recent Congressional action has increased the appropriations for the IRS, specifically for activities designed to improve compliance. The IRS appropriation for 1987 was $422 million greater than the final 1986 appropriation and was $150 million more than requested in the President's budget. It provided funds to hire additional examination staff and other collections personnel, as well as to improve the reporting and processing of information, such as end-of-year wage statements prepared by employers or interest and dividend reports prepared by banks, investment firms, and corporations.

TRA and the Omnibus Budget Reconciliation Act of 1986 (Public Law 99-509) also provided for increased civil and criminal penalties and higher interest charges for noncompliance. In addition, some people argue that the tax rate reductions in TRA may also increase voluntary compliance, since they reduce the cost of reporting an additional dollar of income for most taxpayers.

The amount of revenues raised from compliance initiatives is not a simple function of the increase in IRS appropriations or of increases in tax penalties and interest. It also depends greatly upon administrative decisions within the IRS. For example, estimates of the revenues that an additional IRS examiner might raise vary from about $2 to about $20 per dollar spent on personnel, depending on whether the staff are assigned to simple or complex tax returns, to upper-income or middle-income tax returns, or to businesses or individuals. In addition to short-run revenue yield, administrative decisions are based on other factors, such as the need to examine returns

1. The costs and benefits of IRS enforcement activities are discussed in more detail in C. Eugene Steurerle, *Who Should Pay for Collectng Taxes? Financing the IRS* (Washington, D.C.: The American Enterprise Institute for Public Policy Research, 1986).

across all income levels in order to be perceived as fair and thus sustain voluntary compliance in the long run. The added revenue gain from additional IRS staff may also diminish as staffing levels grow, in part, because tax returns of each type that have the greatest potential revenue are pursued first. Additional uncertainty about the revenue yields from increases in IRS funding is caused by the legislative changes in 1986. Because of the uncertain results of future compliance initiatives, a description of alternatives to improve compliance is not included among the revenue-rais-ing options presented below.

The President's budget for 1988 includes a proposal to increase IRS funding by about $0.4 billion, a portion of which is proposed for improving enforcement. The Administration estimates that revenues will be increased by about $2.4 billion as a result of this funding.

SUMMARY OF THE REVENUE-RAISING OPTIONS

Option REV-01 describes alternatives for raising tax rates for individuals and corporations, while REV-02 describes the effects of repealing or postponing indexing of income tax rate brackets, standard deductions, and other values. REV-03 describes three variants of a federal value-added tax that could be imposed in lieu of increases in existing taxes. REV-04, REV-05, and REV-06 are alternative ways to raise revenues from federal excise taxes.

The next 14 options describe alternatives for broadening the income tax base. REV-07 through REV-10 would alter tax preferences aimed at particular activities or industries. REV-11 through REV-14 would reduce preferences that make some forms of saving more attractive than others. The remaining options for broadening the income tax base (REV-15 through REV-19) concern tax preferences that do not directly encourage saving or investment. The final option, REV-20, concerns ways to broaden the base of social insurance taxes.

The estimate of revenue gains from all of the options were made relative to the CBO baseline budget forecast. The baseline is developed under the assumption that most provisions of the tax code that are currently scheduled to expire will not be extended.

Most of the options have an effective date of January 1, 1988, since changes in income tax law are usually effective at the beginning of a new calendar year. For the excise tax options an earlier date of October 1, 1987, is assumed. A January 1, 1989, effective date is assumed for REV-03 (the value-added tax) because it seems unlikely that this option could be implemented before then.

REV-01 RAISE MARGINAL TAX RATES FOR INDIVIDUALS AND CORPORATIONS

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Addition
Individuals						
Retain Transitional 1987 Tax Rates for an Additional Year	8.6	7.0	--	--	--	15.6
Raise Marginal Tax Rates to 16 Percent and 30 Percent	14.0	27.4	29.6	32.4	35.5	138.8
Raise the Top Marginal Tax Rate to 30 Percent	7.0	14.2	15.5	17.4	19.7	73.8
Add a 33 Percent Bracket	2.8	6.5	8.8	11.4	14.1	43.7
Corporations						
Retain Transitional 1987 Tax Rate for an Additional Year	8.2	5.5	--	--	--	13.7
Raise Marginal Tax Rate to 35 Percent	1.5	2.6	2.9	3.1	3.3	13.4

Significant revenues could be raised by increasing marginal tax rates for individuals and corporations. Raising rates does not increase the complexity of the tax law, imposes no new recordkeeping requirements on taxpayers, and is easy for taxpayers to understand. Rate increases would, however, reduce incentives to work and save. They would also run counter to the changes in the Tax Reform Act of 1986, which will reduce statutory marginal tax rates significantly for both individuals and corporations (though

the act also broadens the tax base). The rate reductions will be phased in, falling in both 1987 and 1988, and are so large that they could be partially reversed to raise large revenues while leaving rates well below those under prior law.

The net effect of the rate reductions and base broadening for individuals is that many taxpayers will have smaller tax liabilities, though some who previously made the greatest use of tax shelters or deductions will see increases in their tax bills. For corporations, the net effect is to raise taxes most for those that were previously able to avoid tax. The act increases the share of revenues to be paid by corporations in 1988 from 10.4 percent under prior law to 13.2 percent under current law. Because the act shifts the tax burden to corporations some people argue that it would be inappropriate to increase corporate taxes further.

Individuals. The income tax rate structure enacted in the Tax Reform Act will have two explicit marginal tax rates--15 percent and 28 percent--beginning January 1, 1988. (The marginal tax rate is the percentage of an extra dollar of income that a person must pay in taxes.) Taxpayers with taxable income in excess of specified levels may also pay a 5 percent surcharge, giving these taxpayers an effective marginal rate of 33 percent. The surcharge is the mechanism for phasing out the value of the 15 percent bracket and of personal exemptions as incomes rise. Taxpayers with incomes so high that the phaseout is complete pay no surcharge, and so face a 28 percent marginal rate. A five-bracket transitional rate structure will apply in 1987. For that year, the rates will range from 11 percent to 38.5 percent.

Maintaining the 1987 transitional rate structure, indexed for inflation, for an additional year would increase revenues by $8.6 billion in 1988 and by $7.0 billion in 1989. Increasing the marginal tax rates to 16 percent and 30 percent would increase revenues by about $139 billion in 1988 through 1992. Increasing only the top rate (to 30 percent) would raise revenues by about $74 billion over the five-year period. Replacing the implicit 33 percent tax bracket with an explicit 33 percent rate that applies to all income above the start of the phaseout of the 15 percent bracket would raise revenues by about $44 billion over five years.

Increasing marginal tax rates would raise a significant amount of money quickly and with few administrative complications. Because the bulk of individual income tax revenues is collected through payments withheld from employee paychecks, the added revenues from an increase in rates would flow into the Treasury as soon as employers changed their payroll accounting practices in accord with the new withholding rates (usually within one to three months).

There is much less difference between the highest and lowest income tax rates under current law than under previous tax law. Under the law prior to 1987, marginal tax rates ranged from 11 percent to 50 percent. Maintaining the 1987 transitional rate structure for an additional year or raising only the top marginal tax rate would increase taxes for upper-income families and reduce or leave unchanged taxes for low-income families. Raising the statutory rates to 16 percent and 30 percent would increase taxes for all families, but would result in a greater proportionate reduction in after-tax income for upper-income families than for low-income families. Adding a 33 percent bracket would raise taxes only for the small number of high-income families for whom the 15 percent bracket and personal exemptions would be completely phased out under current law.

Under any of these proposals the top marginal tax rate on ordinary income would be well below the top rate under the law before 1987. These proposals would, however, further increase the maximum rate on capital gains, which will be significantly higher under current law than under prior law. The maximum tax rate on capital gains will now be 28 percent beginning in 1987 compared with 20 percent under prior law. (Beginning in 1988, the maximum rate can be as high as 33 percent for families with taxable income in the rate adjustment or personal exemption phaseout range.) High marginal tax rates on capital gains could discourage investors from realizing gains. They could also discourage investment in high-growth ventures.

Maintaining the 1987 transitional rate structure for an additional year would reduce taxes for married couples with taxable incomes below $29,750 and raise taxes for those with incomes in excess of $46,280. With rates set at 16 percent and 30 percent, taxes for 1988 would increase by about 7 percent for most families. Raising only the top marginal tax rate (to 30 percent) would increase taxes for 1988 for married couples with taxable incomes over $29,750. The average taxpayer with an increase in taxes would pay 4 percent more. Adding a 33 percent bracket would increase taxes for 1988 by an average of 8 percent for the 400,000 taxpayers who would be affected. A married couple with two children would pay higher taxes under this option if their taxable income was $192,930 or higher.

Corporations. The Tax Reform Act reduces the top statutory rate on corporate income from 46 percent to 34 percent, beginning July 1, 1987. (Tax years that include July 1, 1987, will have a blended rate to prorate the reduction, so that calendar year corporations have a 40 percent rate in 1987.) Lower marginal rates will apply to the first $75,000 of taxable income, but corporations with taxable income above $100,000 will pay a 5 percent surtax until the benefits of the lower marginal rates have been phased out.

Maintaining the 40 percent rate for an additional year would increase revenues by $8.2 billion in 1988 and $5.5 billion in 1989. Increasing the marginal rate to 35 percent (beginning January 1, 1988) would increase revenues by about $13 billion in 1988 through 1992.

Increasing the marginal tax rate would raise corporate taxes quickly without further complicating the corporate tax structure. Because the bulk of corporate tax payments are collected through quarterly estimated payments, the additional revenues could begin to flow into the Treasury during the quarter in which the increase was passed. Even a 40 percent rate would be a significant reduction for corporations that currently pay close to the statutory rate. It would be less favorable for investment, though, than current law.

An increase in the corporate rate could affect the decision a business makes about its form of organization. Businesses may be organized and taxed as corporations, in which case their income is taxed at both the corporate and individual levels. If they choose a noncorporate form, their income is only taxed at the individual level. The Tax Reform Act lowered the maximum individual income tax rate by more than the corporate rate, creating an unprecedented situation in which the corporate rate is higher than individual rates. If a later increase widened the distance between the corporate and individual rates, the incentive for corporations to reorganize in noncorporate form would be increased.

REV-02 AMEND OR REPEAL INDEXING OF INCOME TAX SCHEDULES

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Addition
Repeal Indexing	--	3.6	11.6	23.1	36.9	75.3
Eliminate the Indexing Adjustment Scheduled for 1989	--	3.6	6.3	7.0	7.7	24.6

Before the Tax Reform Act of 1986, the personal exemption amount, standard deduction (zero bracket), and tax brackets were adjusted annually to offset the effects of inflation. The act sets the dollar amounts of the standard deduction (including the extra standard deduction for the elderly or blind) and the tax brackets for 1987 and 1988, but indexes them for inflation in later years. The act sets the dollar amount of the personal exemption for 1987, 1988, and 1989 but indexes it thereafter. The act also indexes the amount and phaseout level for the earned income credit (EIC) for the first time. The options described below would not affect the indexing of the EIC.

Eliminating indexing would raise revenues by $75.3 billion in 1989 through 1992. Eliminating the indexing adjustment scheduled for 1989 would raise revenues by $24.6 billion in the same period. Changes in indexing would gain small amounts of revenue in the first year of enactment, but would raise considerably larger amounts in future years because of the cumulative effects of indexing.

Changes in indexing would raise the taxes of most taxpayers but would not increase taxes of very-high-income families whose tax liability does not depend on the personal exemption or the 15 percent bracket. (The Tax Reform Act phases out the benefits of these values for high-income taxpayers.) Families that use the standard deduction (generally low- and middle-income families) would be more affected by changes in indexing than families that itemize deductions.

The main argument for retaining indexing is that it requires the Congress to decide explicitly on tax increases. Without indexing, inflation causes more-than-proportional increases in tax liabilities as incomes rise;

this results in an increase in real tax liabilities without legislative action even though real income may not have increased or may even have fallen. Some people argue that these automatic tax increases give legislators an incentive to pursue inflationary policies, and they feel that indexing protects against this bias. Other opponents of inflationary policies prefer an unindexed tax code, arguing that tax increases caused by inflation will make inflationary policies less popular politically.

The revenue gains from either eliminating indexing or delaying indexing for one year would be highly sensitive to inflation. A one-percentage-point increase in the rate of inflation in excess of the predicted rate would increase the gains from eliminating indexing by about $24 billion over the five-year period.

REV-03 IMPOSE A VALUE-ADDED TAX

Addition to CBO Baseline a/	Annual Added Revenues (billions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Addition
5 Percent Tax, Comprehensive Base	--	73.8	107.5	110.9	114.3	406.5
5 Percent Tax, Narrower Base, Exemptions for Food, Housing, and Medical Care	--	42.6	62.1	64.0	65.8	234.6
5 Percent Tax, Narrower Base, No Exemptions for Food, Drugs, and Medical Care; Low-Income Relief Under Means-Tested Programs b/	--	56.0	81.5	83.3	84.7	305.3

a. Estimates based on effective date of January 1, 1989.

b. Includes increased outlays for Medicaid, Food Stamps, Medicare, Supplemental Security Income, and Aid to Families with Dependent Children.

A national value-added tax (VAT) could raise substantial revenue at relatively low tax rates. A VAT is typically administered by taxing the total value of sales of all firms, but allowing firms to claim a credit for taxes paid on purchases from other firms of raw materials, intermediate materials, and capital goods. Thus, firms pay tax on their wages, salaries, profits, and interest--their "value added."

A 5 percent tax on a comprehensive VAT base could raise an estimated $73.8 billion in fiscal year 1989 and roughly $400 billion over the 1988 to 1992 period, net of reduced income-tax revenues. A narrower-based VAT could net $42.6 billion in 1989 and over $230 billion between 1988 and 1992. These projections assume that collections would not begin until January 1,

1989, because the IRS estimates that it would take about 18 months after the date of enactment to begin to administer a VAT.

A comprehensive VAT base could exclude only those items that, if included, would make a VAT difficult to administer. A narrower base might exempt food, health care, and other expenditures. This comprehensive base is estimated to have been about $2.5 trillion and the narrower base about $1.5 trillion in 1986. (See the accompanying table.)

If a large amount of revenue is to be raised, a VAT might be preferable to an income-tax increase because it is neutral between present and future consumption, and therefore would not adversely affect incentives for saving and investment as much as an equal increase in income taxes. (Like an income tax, however, it would reduce rewards from work effort.) In addition, it would distort economic decisions less than would an equivalent increase in selective consumption taxes. Finally, surveys indicate that the public regards increases in sales taxes as a fairer way of raising revenue than increases in the income tax.

The major argument used against a VAT is that it is regressive when compared with annual income: the tax per dollar of consumption is the same for all taxpayers, but the ratio of consumption to income falls for people in higher income groups. Some analysts argue, though, that a better measure of regressiveness is to compare the tax with annual expenditures, which vary less than annual income and may be a better indicator of long-run income. Under this measure, a VAT appears less regressive (and some forms of VAT appear proportional).

In any case, a VAT could be made less regressive by allowing exemptions for goods and services consumed by low-income people, although such exemptions would substantially increase costs of enforcement and compliance and would reduce revenues from a VAT. One alternative for offsetting regressiveness would be to allow additional exemptions or credits for low-income people under the federal income tax, though this too would be costly. It would also increase the number of income tax returns filed, adding to the IRS workload.

Another alternative might be to include food and medical care in the narrower tax base, but to increase payments to low-income individuals through means-tested programs such as Medicaid, Aid to Families with Dependent Children (AFDC), Supplemental Security Income (SSI), and Food Stamps. Since medical care would be subject to the VAT, Medicaid and

Medicare benefits would automatically be adjusted to reflect the tax. A 5 percent increase in food stamp, AFDC, and SSI benefits would compensate low-income people for taxes on food, as well as partially offset taxes on other purchases. After accounting for the costs of these additional outlays, this option would reduce the deficit by about $80 billion (net) in 1990, and about $300 billion (net) in the years 1988 through 1992.

Other arguments against a VAT are that any increase in the price level it induces might have inflationary repercussions, and that states would regard a federal sales tax as interfering with their traditional revenue base. In addition, the large revenue-raising potential of a federal VAT is of concern to some people who fear it might facilitate undue growth of the federal government. Finally, a federal VAT would impose administrative costs on the firms paying the tax and claiming credits, and it would require new collection and enforcement personnel and procedures. (The Treasury Department has estimated that a VAT would require 20,000 additional personnel at an annual cost of about $700 million.)

SAMPLE CALCULATION OF A VALUE-ADDED TAX BASE, 1986

Items Included in Tax Base		Amount (In billions of dollars)	Gross Tax at 5 Percent Rate (In billions of dollars)
Total Personal Consumption in GNP		2,723	
Less:	Rent on housing	430	
	Net foreign travel expenditures	10	
	Religious and welfare activities	60	
Plus:	Monetary interest paid by individuals	91	
	New residential construction	170	
Comprehensive VAT Tax Base		**2,485**	**124**
Possible Exemptions for Narrower Base			
	New residential construction	170	
	All medical care	310	
	Food purchased for off-premises consumption	328	
	Food furnished to employees	8	
	Clothing issued to military personnel	0	
	Domestic services	10	
	Financial services provided free of charge	70	
	Expenses of handling life insurance	36	
	Local transit (excluding taxis)	4	
	Clubs and fraternal organizations	5	
	Private education and research	45	
Narrower VAT Tax Base		**1,499**	**75**

SOURCE: Congressional Budget Office.

REV-04 INCREASE ENERGY TAXES

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Addition
Impose Tax on Domestic and Imported Oil ($5 per barrel)	19.7	20.9	21.2	21.4	21.7	104.9
Impose Oil Import Fee ($5 per barrel)	8.1	7.2	7.2	7.7	8.4	38.5
Increase Motor Fuel Tax (12 cents per gallon)	10.6	11.1	10.9	10.8	11.0	54.4
Impose Broad-Based Tax on Domestic Energy Consumption (5 percent of value)	13.4	15.0	16.1	17.0	18.3	79.8

NOTE: These added revenues are net of estimated changes in income, windfall profit, and other taxes. Induced outlay effects are not estimated. The revenue estimates are based on CBO's baseline oil price forecast of $15.30 per barrel in 1988, rising to $17.60 per barrel by 1992. If oil prices differ from this forecast, revenues may be significantly affected. The effective date for all of these proposals is October 1, 1987.

Energy taxes could raise significant amounts of revenue, reduce the country's dependence on foreign oil suppliers, and increase conservation by making energy more expensive. The United States depends on foreign sources for about 29 percent of the oil it consumes, and about 19 percent of its total energy. This dependence exposes the U.S. economy to potential supply interruptions.

Raising energy taxes might lead to reduced energy consumption so that the costs of supply interruptions would diminish. Moreover, reduced demand for imported oil resulting from an energy tax could force foreign

suppliers to absorb part of the tax through lower prices. Finally, energy taxes (by raising energy prices) would help preserve the conservation gains that have been achieved in recent years and that might otherwise be lost because of recent declines in world oil prices.

One argument against energy taxes is that they would absorb a larger fraction of family incomes for low-income taxpayers who spend a relatively high percentage of their incomes on energy. Some analysts counter with the argument that the regressiveness of the tax should be measured against annual expenditures, not income, because expenditures are a better reflection of long-run income. Using this measure, energy taxes appear less regressive. Whichever measure is used, the regressiveness of energy taxes could be offset by small adjustments in income tax rates or by providing energy stamps for low-income people.

Concern has been expressed over the use of energy taxes on several other grounds. Energy taxes could have widely different effects in different parts of the country. For example, one study indicates that taxes that increase the relative price of fuel oil would have the greatest impact on the Northeast region, while taxes that increase the relative price of gasoline would have the greatest impact on the West.1/ In addition, if the imposition of energy taxes raises the Consumer Price Index, indexed federal outlay programs would be affected. Some observers have also argued that stockpiling oil is a more cost-effective way of relieving dependence on imports and would not artificially reduce current energy use by households and businesses. This argument follows from a view that free markets already provide sufficient incentives for resource conservation.

Excise Tax on Domestic and Imported Oil. An excise tax on all oil--both domestically produced and imported--could raise substantial revenue. A $5-per-barrel tax would raise about $21 billion per year and would increase the price of a barrel of oil by about 42 percent or the price of a gallon of gasoline by about 12 cents. Only a portion of the tax would be paid by U.S. consumers or producers. Because the tax would drive down world oil prices, foreign suppliers would also bear part of the burden.

A tax on oil would increase the price that consumers must pay, giving them an incentive to use less oil either through conservation efforts or by switching to an alternative source of energy such as natural gas or coal. Suppliers of oil (both domestic and foreign) would receive a lower after-tax price and so have an incentive to reduce production.

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1. Congressional Budget Office, *The Budgetary and Economic Effects of Oil Taxes* (April 1986).

Since 1981, the average cost of a barrel of oil has dropped from about $35 to under $20. A $5 per barrel oil tax would partially offset this price reduction and help retain incentives for energy conservation efforts and for production from alternative energy sources. The tax would still leave consumers paying significantly lower prices than six years ago. The tax would, however, further depress the after-tax prices that suppliers of oil receive.

Oil Import Fee. As an alternative to an excise tax on all oil, the Congress could impose the tax only on imports. This type of tax was a topic of discussion during the deliberations over the budget resolutions for fiscal years 1986 and 1987. An oil import fee of $5 per barrel would raise about $7 billion per year.

An oil import fee would allow domestic suppliers to charge a higher price and still remain competitive with imports, which would provide an incentive to increase domestic production of oil. Like the tax on all oil, the fee would also serve to maintain conservation incentives by holding up energy prices. These effects would reduce U.S. dependence on foreign oil in the short term, although long-term dependence might be increased if U.S. oil supplies were depleted faster. Some oppose an oil import fee on this basis: they see it as a policy of "draining America first." (This argument is also made regarding tax incentives for extractive industries; see REV-09.) They argue that the United States should take advantage of cheap foreign oil to preserve more expensive U.S. reserves for future use.

With the spot price of oil currently under $19 per barrel, the $5 fee would still leave the total price of oil well below 1981 levels. As with the tax on all oil, U.S. consumers would pay only part of the fee; the rest would be borne by foreign suppliers, who would face a lower world oil price as a result of the tax. One consequence is that some important U.S. trading partners might object to the fee (though others would benefit from a lower world oil price). Exempting oil imports from selected countries such as Canada, Mexico, and the United Kingdom would substantially reduce the fee's revenue potential. Imports from these countries now account for about one-third of U.S. oil imports.

An oil import fee would have different effects in different regions of the country. It would benefit oil-producing states, because producers would receive higher prices, but oil-consuming states--especially in the Northeast--would bear much of the burden of the tax and of the higher prices U.S. oil producers receive.

Additional Motor Fuel Excise Tax. The present federal tax on gasoline and other highway motor fuels is 9 cents per gallon. The revenue from this tax is earmarked for the federal Highway Trust Fund, which pays for construction and improvement of highways, bridges, and mass transit facilities. State governments also impose gasoline taxes ranging from 7 cents to 18 cents per gallon. Compared with other countries, many of which levy taxes of well over $1.00 a gallon, the United States charges one of the lowest tax rates on motor fuel in the world.

An additional federal tax on motor fuels would raise about $0.9 billion per year for each cent per gallon of tax. Because the average national price of gasoline has dropped from a peak of about $1.39 a gallon in March 1981 to about $0.84 in October 1986, an additional tax of 12 cents per gallon would not put the total cost of gasoline above what consumers have already experienced. If proceeds from the additional tax were allocated to general revenues instead of being used to support additional spending from the Highway Trust Fund, they could result in deficit reduction.

Beyond raising revenue, an additional excise tax on motor fuel would reduce consumption of gasoline and diesel fuel and dependence on foreign oil by encouraging people to drive fewer miles or purchase more fuel-efficient cars and trucks. The excise tax would not significantly affect oil consumption for other purposes, such as electricity production or home heating. An argument against a motor fuel tax increase is that it would impose an unfair burden on people who commute long distances by car, compared with other users of energy. The tax would also affect consumers in the southern and western states more than those in other regions.

Broad-Based Tax on All Energy. An alternative to selective excise taxes is a broad-based tax on all forms of energy consumption, whether produced domestically or abroad. A national energy tax would heighten conservation incentives and reduce consumption of all forms of energy. Further, because the tax would apply to all energy sources, it could raise much more revenue at a lower rate than selective taxes. The tax could be imposed as a fraction of the value of fuel, or could be based either on units produced (such as barrels of oil, tons of coal, or cubic feet of gas) or on the heat content of the fuel measured in British thermal units. Unlike a Btu or per unit tax, a tax on energy value would not change relative fuel prices and would not encourage consumers to switch from one form of energy to another. A 5 percent tax on the value of all domestic and imported energy consumption, including coal, petroleum, natural gas, hydroelectricity, and nuclear power, would raise over $16 billion per year in revenues.

REV-05 INCREASE EXCISE TAXES

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Addition
Extend the Telephone Tax	1.3	2.3	2.5	2.7	3.0	11.7
Raise the Cigarette Tax to 32 Cents per Pack	2.9	3.1	3.1	3.0	2.9	15.1
Increase Taxes on Distilled Spirits	0.4	0.6	0.6	0.6	0.6	2.7
Raise Taxes on Beer and Wine to Rate on Distilled Spirits	4.2	5.7	5.8	5.9	6.0	27.6
Index Current Cigarette and Alcohol Tax Rates for Inflation	0.4	0.7	1.1	1.2	1.4	4.8

Additional revenues could be raised by extending the temporary increase in the telephone tax that was imposed in recent tax legislation, and by increasing alcohol and tobacco taxes.

Extend the Telephone Tax. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) raised the excise tax on local and long-distance telephone service and teletypewriter exchange service to 3 percent for calendar years 1983 through 1985. The Deficit Reduction Act of 1984 (DEFRA) extended the 3 percent rate through calendar year 1987. Extending the tax beyond 1987 at the 3 percent rate would raise revenues (net of reduced income taxes) by about $12 billion over fiscal years 1988-1992. Extending the tax and raising the rate to 4 percent would raise net revenues by about $15 billion over the five-year period.

The primary justification for the tax is that it can raise large revenues with a low tax rate. Other arguments for the tax are that it is a broad-

based tax, since virtually all households have telephones, and that the cost to the government of administering the tax is low. One argument against the tax is that it burdens households in proportion to their use of telephone services rather than their ability to pay taxes or some other standard of fairness. The tax is also a larger portion of both household incomes and expenditures for low-income households than for households with higher incomes.1/ Finally, the tax is also criticized because it applies even to basic local telephone service, which many regard as a necessity.

Increase the Cigarette Tax. TEFRA increased the cigarette tax from 8 cents per pack to 16 cents for the period from January 1, 1983, to September 30, 1985. The 16-cent rate was subsequently extended through March 15, 1986, and then made permanent. The tax is now about 15 percent of the current average market price (including tax) per pack, significantly less than the 42 percent of the price that the 8-cent tax represented when it was set in 1951. Increasing the tax to 32 cents per pack on October 1, 1987, would raise net revenues about $15 billion between 1988 and 1992. Increasing the tax to only 24 cents per pack would increase net revenues by about $8 billion over five years.

An increase in the cigarette tax could be seen as compensation for the costs of smoking that society ultimately bears, such as the increased medical costs of both smokers and nonsmokers attributable to smoking. It might also discourage smoking by raising prices, which would probably affect the young most and could result in long-run improvements in health. On the other hand, if the increase exceeded the net costs imposed on other taxpayers by smokers, it could be regarded as discriminatory against smokers (about 30 percent of the adult population). In addition, the tax is a higher share of the income and expenditures of low-income households than of households with higher incomes.2/ Finally, increases in the federal cigarette tax might have an adverse effect on state and local revenues from cigarette taxes and could substitute for state increases in these taxes.

Increase Taxes on Alcoholic Beverages. The tax on distilled spirits was increased by DEFRA to $12.50 per proof gallon effective October 1, 1985. This was the first increase in the distilled spirits tax since 1951, when the rate was set at $10.50 per proof gallon. In 1951, the tax was about 43 percent of the average product price; by comparison, the current tax is about 27 percent. Increasing the tax to $15.00 per proof gallon on October 1, 1987, would raise about $3 billion in net revenues over the 1988-1992 period. At this rate, the tax would be about 32 percent of the average prod-

1. See Congressional Budget Office, "The Distributional Effects of an Increase in Selected Federal Excise Taxes" (Staff Working Paper, January 1987).

2. Ibid.

uct price, still well below that in effect in 1951, and the price of a typical bottle of bourbon would be about 5 percent higher than under the current tax rate.

The per unit taxes on beer and wine have not changed since 1951. Moreover, beer and (especially) wine are currently taxed significantly more lightly than distilled spirits. Increasing the tax rates on beer and wine to the alcohol-equivalent rate of the current tax rate on distilled spirits, effective October 1, 1987, would raise about $28 billion (net) between 1988 and 1992. This would increase the tax on a fifth of wine from 3 cents to 55 cents, and the tax on a six-pack of beer from 16 cents to 65 cents. Similarly, increasing the tax on wine to the alcohol-equivalent rate of the current tax on beer would raise about $5 billion (net) through 1992.

Increased taxes on alcoholic beverages would bring the tax rates more into line with historical rates, and would help to offset the social costs of drinking (such as from alcohol-related automobile accidents). On the other hand, some people argue that increases would make tax rates on alcoholic beverages unjustifiably high compared with the social costs of drinking. Opponents of tax increases argue that alcohol taxes are regressive when measured as a share of household incomes. The CBO study cited above indicates that these taxes account for a higher share of household income for low-income households than for those with higher incomes, but are about the same share of household expenditures for those at all income levels. Opponents also argue that increases in the federal tax rates might interfere with a tax base tapped by the states.

Index Cigarette and Alcohol Tax Rates for Inflation. Indexing the taxes on cigarettes and alcoholic beverages to the Consumer Price Index would ensure that tax revenues keep pace with inflation. Indexing current cigarette and alcohol tax rates to changes in the CPI after October 1, 1987, would raise about $5 billion in net revenues over the 1988-1992 period.

Indexing of these taxes would prevent inflation-induced erosion of tax revenues in a gradual and predictable manner, thereby avoiding abrupt increases in unit rates. On the other hand, some people think excise taxes are an inferior way of raising revenues compared to income or general sales taxes, and would prefer to allow their relative burden to decline over time.

An alternative to indexing would be to convert the unit taxes to *ad valorem* taxes (set as a percentage of manufacturers' prices). This method would accomplish the same objective of tying tax revenues to price increases, although revenue would be tied to the prices of the taxed goods, not the general price level. Administration of *ad valorem* taxes would be more complex because of the need to impute manufacturers' prices when the goods are sold by manufacturer-controlled wholesalers and retailers.

REV-06 REPEAL EXEMPTIONS TO THE GASOLINE EXCISE TAX

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Addition
Repeal Gasohol Exemption and Credit	0.2	0.3	0.3	0.3	0.3	1.2
Repeal Bus Exemption	0.1	0.1	0.1	0.1	0.1	0.5

Excise taxes on motor fuels, tires, truck sales, and truck use are used to finance spending on federal aid for highways. These taxes can be considered user fees, and are earmarked for the federal Highway Trust Fund to be used for investment and maintenance of the highway system. Certain users, including public and private bus services, are partially exempt from these taxes. In addition, gasohol and methanol are exempt from tax (or producers may claim an income tax credit) in an attempt to promote conservation of nonrenewable resources. The President's budget for 1988 includes a proposal to repeal these exemptions plus the exemption from all federal highway excise taxes for state and local governments. Proposals to repeal the gasohol exemption and credit and the exemption for buses are described separately below. In order for the resulting revenues to reduce the deficit, they must be retained in the Trust Fund or allocated to the general fund instead of being used to support additional spending for highways.

Repeal the Gasohol Credit and Exemption. Under current law, gasohol (a mixture of gasoline and at least 10 percent ethanol) is exempt from six of the nine cents excise tax on gasoline. Alternatively, ethanol producers are eligible for a credit taken against their income taxes of $0.60 per gallon. The exemptions and credit apply only to ethanol manufactured from biomass (organic materials) and used as fuel. The ethanol credit and exemptions are scheduled to expire at the end of 1992. Repeal of the credit and exemption for gasohol fuel effective October 1, 1987, would raise $1.2 billion between 1988 and 1992.

Another alcohol fuel produced from biomass--methanol--is completely exempt from tax, but this exemption does not currently decrease revenues because engines now available cannot use methanol as fuel. If the

gasohol credit and exemption are repealed, repeal of the methanol exemption should also be considered for consistency and to prevent a future revenue loss if technological change increases the importance of methanol as a motor fuel.

The credit and exemptions are intended to encourage production of fuels made from renewable resources so that U.S. dependence on fossil fuels will decline. This tax subsidy is particularly helpful to farmers who grow corn, because corn is the primary ingredient used in ethanol production. Given the current low prices of oil, however, production costs of ethanol exceed the price of gasoline even when all tax subsidies and other federal subsidies are taken into account. Other subsidies to encourage ethanol production include the energy investment tax credit, federal funds for ethanol research, and federal loan guarantees for construction of alcohol production facilities.

Repeal of the subsidy is favored by those who believe that it leads to an inefficient use of resources, because it encourages production of high-cost alcohol fuels to substitute for lower-cost gasoline. An argument against repeal of the exemption and credit is that ethanol producers have invested in plant and equipment for ethanol production believing that the exemption and credit will continue at least until 1992. Some of these plants could, however, be converted to other uses, such as production of corn sweeteners. Another argument is that the subsidies help raise farm incomes. A study by the Department of Agriculture has indicated, however, that it would cost less to pay farmers a direct subsidy equal to the amount they would receive as a result of ethanol production than to continue with the tax subsidy.

Repeal the Tax Exemption for Buses. Under current law, public and private buses are generally exempt from paying excise taxes on gasoline, diesel fuel, and tires. Repeal of this exemption effective October 1, 1987, would raise $0.5 billion over the 1988-1992 period.

The purpose of the exemption is to encourage the use of public transportation, which may reduce congestion on roadways and conserve energy. Proponents of this proposal argue that buses should pay these taxes as fees for highway use.

REV-07 REDUCE TAX CREDITS FOR REHABILITATION OF OLDER BUILDINGS

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Addition
Limit Rehabilitation Tax Credits to Historic Renovations	a/	0.1	0.2	0.3	0.3	0.9
Repeal the Credits	0.3	0.7	1.4	1.8	1.9	6.0

a. Less than $50 million.

Tax credits for rehabilitation are intended to promote the preservation of historic buildings; encourage businesses to renovate their existing premises rather than relocate; and encourage investors to refurbish older buildings by partially, if not completely, compensating them for forgoing the higher returns they might achieve from new construction. The Tax Reform Act of 1986 replaced a three-tier rehabilitation tax credit ranging from 15 percent to 25 percent with a two-tier credit of 10 percent for expenditures on structures built before 1936 and 20 percent for buildings certified as historic structures by the Department of the Interior.

The credits favor commercial use over most rental housing and may, therefore, divert capital from more productive uses. Commercial buildings can qualify for the credit even if not in a historic district, but credits for rental housing are available only for historic buildings. In favoring renovation over new construction, the credits may encourage more costly ways of obtaining more housing and commercial buildings.

Rehabilitation may, however, have social benefits: it may lessen the outflow of jobs from urban areas or discourage destruction of historically noteworthy buildings. This latter objective may be accomplished at lower cost by retaining a credit only for renovation of certified historic buildings. Some surveys have indicated that a 15 percent credit would be sufficient to cover both the extra costs of obtaining certification and of historic-quality rehabilitation. If the credit were retained only for historic structures at a 15 percent rate, revenue gains over the 1988-1992 period would be $0.9 billion. Repeal of the credit would raise $6.0 billion over the same period.

REV-08 TAX CREDIT UNIONS LIKE OTHER THRIFT INSTITUTIONS

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1988	1989	1990	1991	1992	
Addition to CBO Baseline	0.2	0.4	0.4	0.5	0.5	2.0

Credit unions, organized for the benefit of members and operated without profit, are not subject to federal income taxes and hence are treated more favorably than competing thrift institutions. Taxing credit unions like other thrift institutions would raise about $0.2 billion in 1988 and about $2 billion through 1992.

Historically, savings and loan institutions, mutual savings banks, and credit unions were tax-exempt because they were regarded as operating for the sole benefit of their members. In 1951, though, the tax exemptions for the first two groups were removed because they were recognized to resemble corporations more closely than mutual organizations. Today, credit unions have more than 43 million members and over $99 billion in assets and are comparable in strength and services to taxable thrift institutions. Permitting the passthrough of income to credit union members with no tax at the "corporate level" gives credit unions a cost advantage. This is contrary to the intent of deregulation of the financial services sector, which was to lessen distinctions among providers of financial services.

The tax acts of 1982, 1984, and 1986 greatly limited the tax preferences of taxable thrift institutions. The resulting increase in the tax burden of taxable thrift institutions increases the competitive advantage that credit unions derive from escaping taxation. Credit unions claim, however, that the original reason for their special tax treatment--that they operate solely for the benefit of their members--justifies their current status.

REV-09 REPEAL TAX PREFERENCES FOR EXTRACTIVE INDUSTRIES

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Addition
Repeal Percentage Depletion	0.5	0.9	0.9	1.0	1.0	4.2
Repeal Expensing of Intangible Drilling, Exploration, and Development Costs	1.1	1.7	1.4	1.2	1.1	6.5
Bring Oil and Gas Losses Within the Passive Loss Limitation	0.1	0.3	0.3	0.4	0.5	1.6

Businesses engaged in extracting hard minerals or energy enjoy tax preferences available only to them in the form of special cost recovery rules. In addition, certain oil and gas investors are exempted from the passive loss limitation enacted in the Tax Reform Act of 1986.

Repeal Special Cost Recovery Rules. Mineral properties, such as oil and gas wells, coal mines, or gravel quarries, are similar to depreciable assets in that they require large "up front" expenditures to produce assets that generate future income. These capital costs for mineral properties are of three types: costs associated with acquiring mineral rights and exploring for possible mineral deposits; development costs, including expenses such as those related to drilling oil wells or mine excavation; and costs for capital equipment, such as pumps or construction machinery. Under general income tax accounting principles, such capital costs may not be deducted immediately (that is, may not be expensed) but must be "capitalized" and recovered in future years through depreciation or depletion deductions. Extractive industries, however, are allowed to expense certain capital costs that normally would have to be depreciated and to take depletion deductions for other capital spending that exceed the actual amount of such spending.

The items that may be expensed are certain exploration and development costs for hard mineral industries (such as coal or iron ore) and much of the costs necessary to prepare and drill wells for oil and gas (called intangible drilling costs). In the case of corporations engaged in hard mineral extraction and integrated producers of oil and gas, expensing is limited to 70 percent of these costs, with the remaining 30 percent deducted over a 60-month period. In addition, hard mineral exploration costs are subject to recapture once a mine is brought into production. (Recapture involves including exploration costs as income in the year the mine begins production.)

Under cost depletion, firms are allowed to deduct costs according to the percentage of estimated reserves produced each year. For example, if 5 percent of a well's remaining reserves is produced in a given year, 5 percent of the well's unrecovered depletable costs is written off in that year. The total amount of cost depletion deductions allowed over time equals the total amount of capitalized costs. Many taxpayers, however, are allowed the alternative of percentage depletion to compute their annual depletion deduction. Percentage depletion allows firms to deduct a certain percentage of the gross income from a property as depletion, regardless of the firm's actual capitalized costs. For example, nonintegrated oil and gas companies are allowed to deduct 15 percent of the gross revenue from their first 1,000 barrels per day of oil and gas production each year, regardless of their capitalized costs. (Integrated oil and gas producers are required to use cost depletion for recovering capitalized costs.) Hard mineral producers are also allowed to use percentage depletion at varying statutory rates. Minerals eligible for percentage depletion include coal (10 percent), uranium (22 percent), oil shale (15 percent), gold (15 percent), and iron ore (14 percent).

The current tax treatment of mineral and energy properties has been criticized because many of the preproduction expenses of mineral properties can be deducted faster than the value of the assets they "produce" declines. For example, drilling expenditures by oil companies produce assets (that is, producing wells) that gradually decline in value as oil reserves are depleted. The tax code, however, allows firms to deduct most of these costs in the year incurred. Moreover, percentage depletion often allows firms deductions in excess of their original investment. In some cases, percentage depletion (in present-value terms) is even more generous than expensing of all depletable costs.

Because of these provisions, mineral and energy producers face effective tax rates that are lower than statutory tax rates and, for many

producers, lower than effective tax rates on other industries. The Tax Reform Act increased the effective rates on most industries by, among other things, replacing the Accelerated Cost Recovery System (ACRS) of depreciation with one that is less generous for many assets and eliminating the investment tax credit. At the same time, the act made only minor changes to tax preferences for extractive industries. These tax advantages could be eliminated by requiring all expenditures on mineral and energy rights, and on exploration, development, and drilling of productive mines and wells, to be capitalized and recovered by cost depletion. (Expenditures on dry holes, unproductive mines, or worthless mineral rights would, however, still be expensed.) Repeal of percentage depletion would raise about $0.5 billion in 1988 and $4.2 billion over the 1988 to 1992 period. Repeal of the expensing provisions would raise about $1.1 billion in 1988 and $6.5 billion over the 1988 to 1992 period.

Opponents of expensing and percentage depletion argue that the inherent subsidy they provide is not needed, and that, as a result of these subsidies, too much capital is allocated to extractive industries as opposed to other more productive uses. Further, the subsidies may cause greater consumption of domestic resources (especially oil and gas) and less of imported resources. Providing the subsidies has been called a policy of "draining America first," which may result in greater reliance on foreign energy producers in the future. (This argument has also been made regarding an oil import fee; see REV-04.) Finally, it is argued that the differential taxation of integrated and independent oil companies is an inefficient way of promoting oil production.

The major argument for retaining the expensing and percentage depletion provisions is that they provide necessary incentives for increasing domestic production of oil, other fuels, and hard minerals. Furthermore, proponents argue that because the oil and gas industry is highly risky, especially for small firms, favorable tax treatment is required so that firms can raise sufficient capital. Moreover, extractive industries are facing particularly hard times at the moment and some people argue that it is a bad time to increase their tax burden. If preferences for extractive industries are not eliminated directly, their use as tax shelters could be curtailed by extending the passive loss limitations to extractive industries, as described next.

Exception to Passive Loss Limitation. As a result of the Tax Reform Act, losses from passive business activities (those in which the taxpayer is not involved in a regular, continuous, and substantial basis) may not be used to offset the taxpayer's other income, such as salary, interest, dividends, and

active business income. This limitation was imposed to reduce tax shelter activity. An exception was made for working interests in oil and gas properties where the taxpayer's liability is not limited by the form of ownership. Repealing this exception for the oil and gas industries would raise $1.6 billion between 1988 and 1982.

This exception was made at a time when world oil prices had declined sharply, reducing profitability for the oil and gas industry. Despite some recent upturn in world oil prices, conditions in the domestic oil industry are still very depressed. Some people argue that the riskiness of oil and gas ventures makes it difficult for them to attract sufficient investment capital, even in relatively good economic times, unless preferential tax treatment is available. Because the exception applies only to investors who are willing to put themselves at substantial financial risk, some argue that it does not seriously undermine the general prohibition on passive losses. This argument, however, could apply equally to other industries that are risky and that are facing adverse market conditions. Further, as discussed above, giving preferences to oil and gas extraction may inappropriately subsidize depletion of domestic resources.

REV-10 ELIMINATE PRIVATE-PURPOSE TAX-EXEMPT BONDS

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Addition
Eliminate All Private-Purpose Tax-Exempt Bonds	0.3	0.9	1.6	2.1	2.5	7.5
Raise Cap and Extend Volume Limits to New Issues of All Private-Purpose Bonds	0.1	0.2	0.4	0.5	0.9	2.1

State and local governments have for many years issued bonds to finance public investments such as schools, highways, and water and sewer systems. In the past 20 years, these governments also have issued a large and rapidly growing volume of bonds to finance both quasi-public facilities, such as ports and airports, and private-sector projects, such as housing and shopping centers. Because interest on most of these "private-purpose" bonds is exempt from federal taxation, rates on them are below-market. These low interest rates reflect the federal subsidy of borrowing costs for private entities. Under current law, revenue losses from private-purpose bonds will amount to $12.5 billion in fiscal year 1988, rising to $13.9 billion in 1992.

"Private-purpose" tax-exempt bonds include mortgage revenue bonds for rental housing and single-family homes for low- and middle-income households; industrial development bonds (IDBs), used by private firms for a wide variety of purposes; student loan bonds, issued by state authorities to increase funds available for guaranteed student loans; and bonds for nonprofit institutions, such as hospitals and universities. Some bonds subsidize activitiés that the federal government may want to encourage, such as low-income housing. Even then, however, tax-exempt financing often merely lowers borrowing costs for investments that would have been undertaken anyway. Regardless of the merit of a subsidy or its effectiveness in increasing investment, tax-exempt financing is an inefficient way to provide assistance. With a direct subsidy, the benefits go entirely to the borrower, and the assistance is a line item in the federal budget rather than a less visible off-budget expenditure. With tax-exempt financing, the benefits are shared shared between the borrower of funds and the investor in tax-exempt bonds.

The Congress has put restrictions on the use of tax-exempt financing several times, beginning in 1968. During the 1980s, these restrictions have, among other measures, included limiting the volume of new issues of tax-exempt bonds for some activities and setting sunset dates on the use of tax-exempt financing for other activities.

Most recently, the Tax Reform Act of 1986 placed a single state-by-state limit on the volume of new issues of IDBs, student loan bonds, and housing and redevelopment bonds. The new state volume limits, which are more restrictive than prior law limits, are the greater of $75 per resident or $250 million a year, until December 31, 1987, and $50 per resident or $150 million a year thereafter. Before the Tax Reform Act, the limit for IDBs and student loan bonds alone was $150 per resident or $200 million. Bonds for publicly owned airports, ports, and solid waste disposal facilities, and for nonprofit 501(c)(3) organizations (primarily hospitals and educational institutions) are exempt from the new volume limits. With the exception of hospitals, however, nonprofit institutions may not issue bonds if they have more than $150 million in tax-exempt debt outstanding. This provision primarily will affect large universities. Tax-exemption for mortgage revenue bonds and for small issue IDBs (under $10 million) used for manufacturing facilities will terminate at the end of 1988 and 1989, respectively.

As a result of the Tax Reform Act, the volume of new, private-purpose bonds over the next five years will be about 20 percent less than it would have been under previous law. But while current law limits the growth of new issues, it does not end it--or the continued drain on federal revenues. If the Congress were to eliminate tax exemption for new issues of private-purpose bonds, revenue gains would amount to $0.3 billion in fiscal year 1988, rising to $2.5 billion in 1992. Eliminating the tax exemption could result in higher construction costs for low-income housing and for nonprofit facilities, unless, of course, the Congress provided direct subsidies as a substitute.

Including all bonds for private nonprofit and quasi-public facilities in a single state volume limit and raising the limits beginning in 1988 to $75 million per capita or $200 million a year would raise $2.1 billion over the 1988-1992 period. This would curb the growth of all private-purpose bonds, without sharply reducing their use from current levels. More stringent limits of $50 per capita or $150 million per state for all private-purpose bonds would raise $2.7 billion over the 1988 to 1992 period. Most bonds for nonprofit institutions finance hospital construction and renovation. Advocates of the bonds maintain that they lead to lower hospital and Medicare costs. Those who support limiting or eliminating these bonds question the need for any subsidy when the supply of hospital beds seems to be adequate.

REV-11 TAX CAPITAL GAINS AT DEATH

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1988	1989	1990	1991	1992	
Addition to CBO Baseline	a/	4.9	5.3	5.6	6.0	21.9

a. Less than $50 million.

Realized capital gains are taxed as income. An exception occurs when a person sells an inherited asset, in which case only the gain accrued after the date of inheritance is included in taxable income. (A portion of the inheritance may be taxed under the separate estate and gift transfer tax, but only if the estate is large.) The income-tax exception could be removed either by taxing capital gains on the decedent's final income tax return, or by requiring the beneficiary to carry forward the decedent's cost basis (generally the original purchase price, less any adjustments). Taxation of gains at death would raise about $22 billion from 1988 through 1992.

Taxing gains at death would reduce both the incentive and the opportunity for wealthy families to avoid tax permanently on an important source of their income. It would also reduce the incentive for investors to hold onto assets longer than is economically sensible. This incentive was strengthened by the Tax Reform Act of 1986, which raises the tax rates on capital gains realized before death. This rise, combined with recent reductions in the estate and gift tax, may significantly increase the amount of capital gains held until death to escape taxation.

The major arguments against taxing gains at death are that it would reduce the incentive to save by raising the expected value of future capital gains taxes, and that it might force estates to liquidate assets such as small farms or businesses in order to pay the tax. The forced-sale problem could be reduced by allowing generous averaging provisions and deferral of tax payments.

As an alternative to taxing gains at death, the heir could be made to carry forward the decedent's cost basis (carryover basis). This requirement would avoid the liquidity problem mentioned above because carryover basis allows a continued tax deferral on the unrealized gain for heirs. Enacting

carryover-basis provisions would raise $3.5 billion from 1988 to 1992. The Congress enacted carryover basis for assets transferred at death in the Tax Reform Act of 1976, but this provision was postponed for three years in the Revenue Act of 1978, and was repealed in 1980. One of the chief objections to the provision was the difficulty estate administrators and heirs experienced in determining the decedent's basis. This problem resulted in part from the fact that the provision required new documentation not previously needed to comply with tax law. It might be lessened over time, as taxpayers take the provision into account when planning their estates. Neither carryover basis nor the taxation of gains at death is included in the Tax Reform Act of 1986.

REV-12 TAX 30 PERCENT OF CAPITAL GAINS FROM HOME SALES

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year
	1988	1989	1990	1991	1992	Addition
Addition to CBO Baseline	0.4	2.0	2.2	2.3	2.5	9.4

The tax on the capital gain from the sale of a principal residence is deferred if the seller purchases another home of at least equal value within two years. If the taxpayer dies before paying tax on the gain, this tax is never owed (see REV-11). (Estate taxes may be due, but only for those with extremely large estates.) Further, taxpayers aged 55 and over may exclude up to $125,000 of gain from a home sale that is not rolled over (the exclusion may only be taken once). Thus, in practice, a large portion of capital gains from home sales is never taxed. If the above provisions were replaced with a tax on 30 percent of capital gains from home sales, $9.4 billion could be raised in the 1988-1992 period.

The current provisions are defended on the grounds that they may prevent hardships for homeowners forced to sell because of a change in family size or unexpected employment change. Some claim they are needed to protect taxpayers from a large tax liability on a lifetime capital gain, and to avoid taxing the portion of that gain that might be attributable to inflation. This latter problem, which is no greater for housing than for other assets, could be avoided with an explicit adjustment for inflation.

The tax code strongly favors owner-occupied homes over other investments (for further discussion of this point, see REV-16). Because capital gains from homeownership are taxed more lightly than gains from stock and other business investment, savings are diverted from more productive investments into housing. The Tax Reform Act increases the value of the tax deferral for home sellers under age 55 because it significantly increases the tax rate on capital gains, thus increasing the incentive for them to reinvest in housing rather than other assets.

To make the treatment of housing more like that of other assets, the deferral and exclusion provisions could be replaced with a small tax on gains from home sales. Under this proposal, the gain on one home would not

affect the calculation of gain on successive homes--each purchase of a home would be a separate transaction for tax purposes. This change would simplify both tax administration and taxpayer compliance, especially for those who change homes often, because it would eliminate the need for homeowners to keep track of gains and expenses from a succession of homes. If 30 percent of the gain were included in taxable income, the tax on home gains would be less than 10 percent for taxpayers with the highest marginal tax rate, and would be only 5 percent for those in the 15 percent bracket.

A tax on home gains would lessen but not eliminate the incentive to reinvest gains from home sales in housing. For some taxpayers, it could have the effect of discouraging home sales, just as current law provides an incentive for taxpayers to hold, rather than sell, other capital assets. The economic losses caused by this "lock in" effect might be more serious in the case of home sales than for other assets, especially if families were discouraged from relocating to change jobs. The tax might also deter some homeowners (especially older taxpayers with large accrued gains) from changing homes as family requirements change.

REV-13 DECREASE LIMITS ON CONTRIBUTIONS TO QUALIFIED PENSION AND PROFIT-SHARING PLANS

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Addition
Decrease Limits to $45,000 and $15,000	0.9	2.5	2.8	3.2	3.6	12.9
Decrease Limits to $67,500 and $22,500	0.2	0.6	0.6	0.7	0.8	2.9
Repeal Salary Reduction Plans	2.8	5.7	6.2	7.1	8.1	29.8
Decrease the Limit for Deferrals in Salary Reduction Plans to $5,000	0.1	0.3	0.3	0.4	0.4	1.4

Participating in qualified plans is an advantageous way for most taxpayers to save for retirement. The advantages are twofold. First, the investment income earned within qualified plans is not taxed. Second, most deposits to qualified plans are not taxed until they are distributed in retirement, when many taxpayers face relatively low tax rates.

Decrease Limits on Employer Contributions. Retirement payments from defined contribution plans depend on annual contributions, usually expressed as a percentage of each year's earnings, while defined benefit plans specify the pension to be received, usually expressed as a percentage of preretirement earnings. Currently, contributions to defined contribution plans are limited to the lesser of 25 percent of compensation or $30,000 per employee, and contributions to defined benefit plans are limited to amounts that will result in annual benefits of the lesser of 100 percent of wages or $90,000 per employee for any pension that begins at age 65. (For pensions that begin at an earlier age, this limit is reduced on an actuarial basis.) When an employee is eligible for payments from both types of plans sponsored by the same employer, a combined limit applies--the lesser of 140 percent of wages or $112,500 in annual payments.

These funding limits are far higher than the preretirement earnings of most workers. Only one-half of one percent of employees earn more than $112,500 a year. Many analysts have questioned the need to subsidize the accumulation of retirement income to replace earnings up to such high levels, particularly because many workers (especially in the lower half of the income distribution) are not covered by qualified plans and thus do not have access to these subsidies for retirement saving.

If the dollar funding limits for defined benefit plans were lowered to the Social Security wage base ($43,800 in 1987 and $45,000 in 1988), with equivalent reductions in limits for defined contribution plans, the limits would still be higher than the earnings of all but about 7 percent of earners. (The 7 percent of top earners would continue to be subsidized for retirement savings in qualified plans up to the wage base.) Lowering the limit to $45,000 for defined benefit plans and $15,000 for defined contribution plans in 1988 would raise $12.9 billion in 1988-1992. Alternatively, the limits could be lowered to amounts somewhere between current law and those compatible with the Social Security wage base. Limits of $67,500 and $22,500 in 1988 would raise $2.9 billion over five years, and would exceed the earnings of all but about 2 percent of earners.

An argument against reducing dollar funding limits is that individuals with higher incomes would have much less of their earnings replaced in retirement by payments from qualified plans. Such people, who either own most businesses or constitute top management, might decide not to sponsor qualified plans. If that were to happen, then even more workers than now would be excluded from the tax advantages of qualified plans.

Change Salary Reduction Arrangements. Most salary reduction arrangements are part of employer-sponsored profit-sharing plans that allow employees to choose to receive lower current (taxable) compensation and to defer the remainder of compensation as a contribution to the plan. These arrangements typically are called 401(k) plans after the provision of the tax code that authorizes them. Similar arrangements are possible for workers in the nonprofit sector (so-called 403(b) tax-sheltered annuities), for federal workers, and for workers enrolled in some Simplified Employer Plans (SEPs).

The Tax Reform Act of 1986 lowered the cap on the employee deferrals for 1987 in salary reduction arrangements to no more than $7,000 in the case of 401(k) plans, SEPs, and the federal plan, and to no more than $9,500 for 403(b) tax-sheltered annuities. The $7,000 limit will be indexed for inflation starting in 1988. The act also made it easier to maintain 401(k) plans, and it authorized salary reduction arrangements as part of SEPs.

Many people question whether the tax advantages associated with salary reduction arrangements are equitably distributed, because elective deferrals are used mostly by high-income employees with discretionary income. Others argue that the incentive of before-tax savings for employees is unnecessary because those who choose to make elective deferrals would probably save for their retirement anyway. Two proposals to reduce the tax preferences were discussed in the tax reform debate of 1984-1986. One proposal was to repeal 401(k) arrangements. If this proposal was broadened to include all types of salary reduction plans, $29.8 billion would be raised from 1988 through 1992. Another proposal was to limit elective deferrals to $5,000 a year. In comparison to the recently enacted $7,000 and $9,500 limits, a $5,000 limit would raise $1.4 billion through 1992.

On the other hand, salary reduction arrangements are attractive to employers because they are relatively easy to administer. This may encourage employers to extend the advantages of qualified plans to the half of the labor force not now covered. Before further changes are made in salary reduction plans, it may be advisable to see whether these plans are becoming available to workers who otherwise would not be covered by qualified plans.

REV-14 IMPOSE A 5 PERCENT TAX ON THE INVESTMENT INCOME OF QUALIFIED RETIREMENT PLANS AND IRAS

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1988	1989	1990	1991	1992	
Addition to CBO Baseline	2.1	3.6	3.8	4.0	4.2	17.6

Under normal income tax rules, deposits to savings accounts are made from income that has been previously taxed. In addition, the investment income earned by those deposits is normally taxable in the year in which it is earned (except for capital gains, which are usually taxed in the year when the capital asset is sold.) In contrast, most deposits in a qualified pension or profit-sharing plan are not taxable until they are distributed from the plan (see REV-13). Equally important, the investment income earned on these contributions or deferrals in qualified plans accumulates tax free.

The tax-free buildup of investment income in qualified plans increases the retirement income workers receive by saving through such plans. Because about half of the labor force does not have access to qualified plans at any given moment, many question whether this subsidy is equitably distributed. The subsidy could be reduced in several ways. If the investment income of qualified plans were allocated to plan participants and taxed as other income, the subsidy would be eliminated, but deciding on proper allocation rules would be very difficult, especially for defined benefit plans. Alternatively, the investment income of qualified plans could be taxed according to the income tax rules that apply to taxable trusts. Generally, beginning in 1988, this would mean taxing the investment income at 28 percent. As a result, however, most workers would be taxed on their share of plan investment income at a rate higher than their usual tax rate. This change would also seriously disrupt the long-term funding arrangements of defined benefit plans. In contrast, a special low-rate tax on the investment income of qualified plans would pose fewer problems but would raise significant amounts of revenue. A 5 percent tax, for example, would raise $17.6 billion between 1988 and 1992.

There are several disadvantages to a special tax, even one with a low rate. First, the tax would complicate the administration of qualified plans. Second, plans would have a greater incentive to switch from bonds and high-yield stocks to growth stocks in order to delay tax on the investment income, which might increase the investment risks faced by sponsoring employers and participants. Third, the tax would reduce retirement income for all participants, including middle-income participants. In contrast, lowering the permissible amounts of before-tax contributions, as in REV-13, would affect only those at the very upper end of the income distribution.

REV-15 FURTHER RESTRICT DEDUCTIONS FOR BUSINESS ENTERTAINMENT AND MEALS

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Addition
Disallow Deductions for Half of Business Entertainment and Meal Expenses	1.3	2.4	2.8	3.2	3.6	13.4

The tax code generally allows deductions for expenses necessary to earn income (except for most employee expenses). It is very difficult, however, to distinguish between the portion of meal and entertainment expenses required for business purposes and those that give rise to personal consumption, such as theater and football tickets, country club dues, and parties or meals at expensive restaurants. The Tax Reform Act of 1986 limits deductions for business meals and entertainment to 80 percent of expenses. It also disallows the portion of expenses that is "lavish and extravagant under the circumstances," a standard that previously applied only to expenses for business travel. Special rules further restrict deductions for the rental of skyboxes in sports facilities.

Further limiting the deduction for business meal and entertainment expenses has been proposed on grounds of both equity and efficiency. Some people argue that even 80 percent of these expenses is greater than necessary to conduct business. They also argue that it is not equitable to permit a few taxpayers to deduct 80 percent of expenses for items such as football tickets, while most people must pay the full cost. Another argument is that the deduction encourages more spending on entertainment than would occur if these activities were not subsidized by the tax system. About $13.4 billion would be raised in the 1988-1992 period if the limit on deductions for business meal and entertainment expenses was reduced to 50 percent of expenses.

This proposal could have some negative effects on the restaurants, sports, and entertainment industries because a large fraction of their income is derived from business customers. For example, fully one-third of all baseball tickets and one-half of all hockey tickets are purchased by business firms.

REV-16 LIMIT MORTGAGE INTEREST DEDUCTIONS

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Addition
Limit Deductions to $12,000 per Return (Single) or $20,000 (Joint)	0.4	1.0	1.1	1.2	1.4	5.1
Limit the Value of Deductions to 15 Percent	1.4	9.5	10.6	11.7	12.7	46.0
Phase Out Deductions for Second Homes	0.1	0.2	0.3	0.3	0.4	1.3

A home is both the largest consumer purchase and the main investment for most Americans. The tax code has historically treated homes more favorably than other investments (see REV-12), by allowing homeowners to deduct mortgage interest expenses but not taxing the current income or most capital gains from the home. (The current income from a home is the value of the housing services that the home provides.) The Tax Reform Act of 1986 increases the tax advantages of homeownership relative to other consumer purchases or assets. The act preserves the deductibility of mortgage interest on first and second homes, but phases out the deductibility of other consumer interest by 1990, and limits the extent to which deductions for carrying assets other than first and second homes can exceed income from assets. Under the act, the size of the mortgage on which interest can be deducted is limited to the purchase price of the home plus the value of home improvements, plus educational or medical expenses. This limit will prevent many taxpayers from deducting interest on home equity loans to finance consumer purchases or assets.

The mortgage interest deduction is defended because it encourages homeownership and home improvement, which can improve neighborhoods for all residents. This deduction has always been allowed under the federal income tax; the subsidy it provides is incorporated into prices and invest-

ment decisions and could not be eliminated without causing significant capital losses for millions of current homeowners.

Much of the subsidy, however, goes to upper-income taxpayers who would probably purchase homes anyway, while some lower-income homeowners may receive little or no benefit from the deduction because they never itemize deductions. The subsidy to the highest-income taxpayers could be limited by capping the mortgage interest deduction at $12,000 per tax return ($20,000 for a joint return and $10,000 for married couples who file separately). This change would raise $5.1 billion from 1988 through 1992, and would affect less than one-half of one percent of taxpayers.

The proposal would retain the basic incentive for homeownership but would not subsidize the luxury component of the most expensive homes and vacation homes. It would also improve economic efficiency because it would reduce the incentive to invest in housing, which might lead to more investment in other productive assets that are not subsidized. The dollar limits would also be easier for taxpayers to comply with and for the IRS to enforce than the limits imposed in the Tax Reform Act. Finally, limits of $12,000 and $20,000 are higher than the deductions for virtually all taxpayers, and so would cause a minimum of disruption to home prices and home building.

If the limit were not indexed, inflation would gradually extend the limit to more and more homeowners. At the current 3 percent inflation rate, the limit would be effectively halved in 23 years. Phasing down the limit through inflation would make the adjustments for most homeowners and home builders gradual. Owner-occupied housing now accounts for about one-third of national investment, so phasing down the tax incentive for housing investment could free substantial savings for other investments.

This proposal might unfairly penalize those who live in areas where real estate prices are high. Enforcement might also be difficult, because some taxpayers could use other assets as collateral for a loan used to purchase a home. In this way, the interest would be deductible even if it exceeded the cap.

Another way to direct the subsidy to lower-income taxpayers would be to limit the tax savings from the current deduction to 15 percent of interest paid, the value of the deduction to those in the lowest tax bracket. This would increase revenues by $46 billion over the 1988-1992 period, and would provide the same benefit per dollar of mortgage interest paid for taxpayers at all income levels. The limit probably would cause capital losses for owners or builders who have already invested in expensive homes.

A final alternative would treat deductions of mortgage interest for second homes like deductions of other consumer interest, which will be phased out by 1990. Most second homes are vacation homes, and some people argue that a tax subsidy for such a luxury is inappropriate, especially when deductions for interest on most loans for other purposes (such as automobile loans) will be phased out. The argument is also made that it is unfair to treat loans for vacation homes differently from loans to finance vacations in resorts or motels. The deduction for interest on second homes is defended because its repeal would reduce the values of vacation homes to owners and builders who have already invested in them. If deductions for interest to finance second homes were treated like deductions for other consumer interest, $1.3 billion would be raised in 1988 through 1992.

REV-17 ELIMINATE DEDUCTIBILITY OF STATE AND LOCAL TAXES

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Addition
Eliminate Deductibility of State and Local Taxes	3.4	22.9	24.6	26.5	28.5	105.9
Maintain Deductibility of Taxes Above Floor of 1 Percent of AGI	0.6	3.9	4.3	4.7	5.1	18.7
Prohibit Deductibility of Taxes Above Ceiling of 7 Percent of AGI	0.7	4.5	4.9	5.2	5.5	20.8

Under current law, taxpayers may deduct state and local income, real estate, and personal property taxes from their adjusted gross income (AGI). These deductions will cost the federal government about $125 billion between 1988 and 1992.

The deductions mean, in effect, that itemizers pay state and local taxes at lower, or subsidized, rates and thus may be willing to support higher levels of state and local services than they would otherwise. In this way, the deductions may indirectly increase state and local revenues at federal expense. The Tax Reform Act of 1986 reduced the subsidy to state and local governments by repealing the deduction for state and local sales taxes, increasing the standard deduction, and lowering marginal rates, thus reducing both the number of itemizers and the value of the subsidy to them.

Deductibility of state and local taxes has drawn criticism on several grounds. For itemizers, the deductions lower the cost of supporting public services. The higher the income level in a community, the more itemizers it will have, and the greater the likelihood that residents will support a higher

level of spending, particularly for such services as public education. This higher spending--which all federal taxpayers subsidize, whether or not they benefit from itemizing or from better public services--may increase disparities among communities. Deductibility may also discourage states and localities from financing services with nondeductible user fees, which would permit more efficient pricing of some services. Moreover, the deductions reduce federal tax liability only for itemizers and, because the value of an additional dollar of deductions increases with the marginal tax rate, the deductions are worth more to higher-bracket taxpayers.

Because their value increases with a taxpayer's bracket, the deductions may encourage states to impose more progressive taxes than they otherwise would. Moreover, supporters of deductibility note that any higher public expenditures resulting from it benefit all members of a community, including lower-income nonitemizers who do not receive a direct tax saving. Increased spending on such public goods as education, transportation, and pollution control may also have spillover benefits for residents outside the taxing jurisdiction. Further, now that direct federal subsidies such as revenue sharing have been virtually eliminated, the alternative to deductibility may be lower spending for state and local services. Finally, deductibility may be a legitimate adjustment in measuring net income and, therefore, the ability to pay taxes.

Limiting the value of the state and local deduction could raise significant revenues. Eliminating deductibility would raise $106 billion in the 1988-1992 period. In its consideration of tax reform, however, the Congress chose to continue deductibility. Most of the effect of the present deductions on public spending could be preserved if the deductions were permitted only for state and local tax payments above a fixed percentage of AGI. The average itemizer's state and local tax deductions exceed 1 percent of AGI in every state. If the floor were set at 1 percent, revenues over the 1988-1992 period would increase by $18.7 billion. Another alternative would be to prohibit deductions above a fixed ceiling, which also might be a percentage of AGI. A ceiling set at 7 percent of AGI would increase revenues by $20.8 billion over the 1988-1992 period. While both a floor and a ceiling would raise revenues, their effects in other respects would differ. With a floor, the incentive for increased state and local spending would remain; with a ceiling, the incentive would be gone. Moreover, a ceiling would result in greater variation in after-tax income from state to state. While it would raise the federal tax liability for residents of high-tax states, it might have little effect on the federal tax liability of residents of low-tax states.

REV-18 INCREASE TAXATION OF NON-MEANS-TESTED ENTITLEMENT BENEFITS

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Addition
Increase Taxation of Social Security and Railroad Retirement Tier I						
Tax 50 percent of benefits	2.1	7.1	7.5	7.8	8.2	32.7
Tax 85 percent of benefits	4.6	15.6	16.8	17.9	19.1	74.0
Tax Workers' Compensation and Black Lung Benefits	1.0	3.2	3.5	3.8	4.1	15.6

Certain entitlement benefits are included in adjusted gross income (AGI), while others are completely or partially excluded. Until recently, most entitlements were exempted from income taxation, but the revenue loss from the tax exemptions was negligible as long as transfer payments were small and the beneficiaries were mostly lower-income households. In recent years, however, transfers have reached more well-to-do households and gradually come to account for a large fraction of family income. Under current law, only a portion of Social Security benefits and Railroad Retirement Tier I benefits is taxed, and the income-maintenance portion of workers' compensation benefits is not taxed at all. Proposals to increase taxation of these benefits are described below.

Increase the Taxation of Social Security and Tier I Railroad Retirement Benefits. Under current law, AGI includes the lesser of one-half of Social Security and Tier I Railroad Retirement benefits or one-half the excess of the taxpayer's combined income (AGI plus nontaxable interest income plus one-half of Social Security and Tier I benefits) over a threshold amount. The threshold amount is $25,000 for single returns and $32,000 for joint returns. Taxation of these benefits can be increased by reducing or eliminating the threshold and by raising the fraction of benefits included in AGI.

Eliminating the threshold would have several advantages. First, it would make the taxation of these benefits more consistent with the taxation of other pension benefits. If half of these benefits were taxed, the tax treatment would be roughly comparable over a worker's lifetime to the tax treatment of noncontributory pensions. Taxation of 85 percent of benefits would be roughly comparable to the tax treatment of contributory pensions for those with the lowest rate of return in Social Security and more favorable than the tax treatment of contributory pensions for other beneficiaries. Second, eliminating the threshold would reduce work or saving disincentives now facing beneficiaries with incomes near the threshold. For these taxpayers, an additional dollar of earnings results in an additional $1.50 of taxable income, as more benefits become taxable. In effect, these taxpayers face marginal tax rates 50 percent higher than statutory rates. Third, the complicated calculations under current law involving thresholds would be eliminated, thus simplifying tax compliance and administration.

Eliminating the thresholds would, however, reduce the current after-tax level of Social Security benefits, lowering the standard of living of many of today's elderly people. This reduction would be regarded by many as a violation of a social contract. Moreover, because Social Security is a larger fraction of the retirement income of middle-income elderly and disabled people than of upper-income retirees, taxing their benefits at even a relatively low marginal tax rate would have a greater effect on their after-tax disposable income than it would on those higher in the income distribution. To offset this tax policy change, benefit levels could be increased, but this would reduce net revenues gained from the proposal. (Because the Tax Reform Act of 1986 increases the personal exemptions and the standard deduction, and allows an additional standard deduction for people 65 and older, very-low-income people would remain tax-exempt even if all Social Security benefits were included in AGI.)

Instead of eliminating the thresholds, they could be lowered. If they were reduced to $12,000 for single returns and $18,000 for joint returns, the taxation of benefits would not affect current beneficiaries in the lower portion of the income distribution. Compared with eliminating the thresholds, lowering them would decrease the five-year revenue gain from about $32.7 billion to $14.2 billion if 50 percent of benefits were included in AGI, and from $74.0 billion to $39.5 billion if 85 percent of benefits were included in AGI. As has happened with the thresholds under current law, inflation would slowly erode the value of these new thresholds and gradually move the result toward full taxation of 50 percent or 85 percent of benefits.

Tax Workers' Compensation and Black Lung Benefits. Workers' compensation benefits reimburse employees for medical costs and lost income result-

ing from work-related injuries. Black Lung benefits reimburse disabled coal miners who have pneumoneucleosis for medical costs and lost income. Two-thirds of workers' compensation benefits is intended to replace lost income and pay benefits to survivors, and the remaining one-third covers medical costs. These benefits are not taxable under current law, and in some cases the after-tax value of wages for those able to return to work is less than their tax-free benefits. Including the income-maintenance portion of these benefits in AGI would make its tax treatment consistent with that of other forms of income and would reduce work disincentives for disabled workers. Taxing the income-maintenance portion of workers' compensation benefits and Black Lung benefits would add $15.6 billion to revenues in 1988 through 1992. A proposal to include the income-maintenance portion of Black Lung benefits is included in the President's budget for 1988.

Opponents of these proposals argue that damages for nonwork-related injuries are not subject to tax, even though a portion reimburses for income loss, and that taxation of workers' compensation benefits would treat these two types of compensation inconsistently. Of course, consistency could also be achieved by taxing the income-replacement portion of all damages for injuries, whether work-related or not. Opponents also argue that taxation of benefits would not significantly increase the incentive to work.

Tax Other Entitlement Benefits. Other entitlement benefits currently not subject to tax include: the value of Medicare Hospital Insurance (HI) coverage in excess of an individual's HI payroll contribution; the subsidy for Supplementary Medical Insurance premiums (SMI) under Medicare; and all means-tested entitlement benefits. A proposal to include the value of HI coverage in excess of an individual's contributions and to tax the insurance value of SMI benefits in AGI is discussed elsewhere (see ENT-09). Revenue gains from including benefits from means-tested programs, such as Aid to Families with Dependent Children, in AGI would be small because few people who qualify for means-tested programs would have enough income to incur any federal income tax liability.

REV-19 TAX NONRETIREMENT FRINGE BENEFITS

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Addition
Tax Some Health Insurance Premiums	(See ENT-13)					
Tax Life Insurance Premiums						
Income tax	1.2	1.8	1.9	2.0	2.1	9.0
Payroll tax	0.6	0.9	1.1	1.0	1.1	4.7

Some employer-paid, nonretirement fringe benefits are excluded from the income and payroll tax bases even though they constitute current compensation to employees. This exclusion reduces revenues substantially. For employer-paid health and life insurance premiums alone, the revenue loss will be about $20 billion in income tax revenues and about $18 billion in payroll tax revenues in 1989 alone. The Tax Reform Act of 1986 preserved the exclusions of fringe benefits in most cases, but it reduced marginal tax rates, which decreases the revenue loss and may slow the pressure from employees to increase the percentage of total compensation that is received tax free.

In addition to employer-provided health and life insurance, statutory tax-free benefits are employer-paid dependent care and miscellaneous benefits, such as employee discounts, meals provided on premises for the convenience of the employer, benefits provided at no additional cost to the employer, on-premises athletic facilities, and *de minimus* fringe benefits. The exclusions of legal service plans and educational assistance benefits were extended to December 31, 1987, by the Tax Reform Act.

Arguments against the exclusions can be made on the basis of efficiency. Employees may bargain for tax-free benefits that they would not be willing to pay for out of after-tax income, increasing demand for the tax-free services. For example, employer-paid health insurance plans may have contributed to the strong growth in demand for health care, which may have contributed to recent sharp rises in health care costs. The higher prices are paid by all who need health care, not just recipients of tax-free insurance.

Strong equity arguments exist also for taxing fringe benefits. At present, a taxpayer receiving no fringe benefits pays more tax than another with the same total income but a larger share in the form of fringe benefits. Further, the benefits of the exclusion are greater for those with higher incomes, both because they face higher marginal tax rates and because they often receive more fringe benefits.

An equity argument can, however, be made for retaining a partial exclusion. A taxpayer with an all-cash income may have a greater ability to pay taxes than one with the same total income who receives a large percentage of income as employer-paid benefits, because these benefits may not be worth as much to the taxpayer as an equal dollar amount of cash wages.

Assessing the value of some fringe benefits for purposes of taxation would be very difficult, in part because the cost to the employer does not necessarily equal the value of the fringe benefit to the employee. Further, the costs of collecting taxes on small fringe benefits (such as employee discounts) could exceed the revenue collected. The inclusion of employer-paid health insurance and life insurance premiums in the tax base would pose only minor administrative problems. The premiums paid to each employee could be reported on the employee's W-2 form, and withholding computed as it is for other taxable income, as is already done for some life insurance premiums (as noted below). The measurement of insurance values is more difficult when benefits are provided directly, as when employers provide medical care or reimburse employees for medical costs incurred (under self-insurance plans).

Tax Some Employer-Paid Health Insurance Premiums. Health insurance premiums were made subject to nondiscrimination rules for the first time in the Tax Reform Act. These rules limit the extent to which employer-paid health plans may favor higher-paid workers. Still, the present exclusion for employer-paid health insurance premiums has been criticized as inequitable to those who must pay for their health insurance with after-tax dollars. The self-employed can exclude only 25 percent of their health insurance costs now, and none of them after 1989; and taxpayers who pay for their own health insurance can deduct the cost of their insurance only if their total medical expenses exceed 7.5 percent of their AGI. Two proposals to tax some employer-paid health insurance premiums are described in ENT-13.

Tax Employer-Paid Life Insurance Premiums. Employer-paid group term life insurance premiums are currently excluded from taxable income, but the exclusion is limited to the cost of the first $50,000 of insurance, and nondiscrimination rules apply. The exclusion is not available to the self-employed. Repeal of this exclusion in the income tax would add $1.2 billion

to revenues in 1988. Eliminating the payroll tax exclusion would add $0.6 billion (net) in revenues in 1988. Over the 1988-1992 period, repeal would yield about $9.0 billion and $4.7 billion (net), respectively. An alternative to repeal would be to reduce the limit on the exclusion. The budget effects shown here for the payroll tax include the minor reductions in income tax revenues that result from the payroll tax increases.

Many employers provide death benefits under pension plans as substitutes for life insurance. Employer contributions to pension plans are income tax-deferred (and the first $5,000 of death benefits paid are tax-exempt) and are exempt from the payroll tax. If only employer-paid life insurance plans were made taxable, employers might choose to offer less life insurance and larger pension plan death benefits instead.

REV-20 BROADEN THE SOCIAL SECURITY TAX BASE

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Addition
Extend HI Coverage to State and Local Government Workers Not Now Covered	1.3	1.9	1.9	2.0	2.1	9.3
Extend OASDI Coverage to New State and Local Government Workers	0.2	0.9	1.5	2.1	2.8	7.5

Until 1982, government workers were not required to pay Social Security payroll taxes. Since then, legislation has made Social Security coverage virtually universal. All federal workers were required to contribute to Medicare Hospital Insurance (HI) beginning in 1982. After 1983, new federal employees were required to contribute to the Old Age and Survivors Disability Insurance (OASDI) trust fund. New employees of state and local governments (those hired after March 31, 1986) were covered by HI in 1985. Proposals to extend coverage further were considered during the budget reconciliation process in the last two years. One proposal would extend HI to state and local employees not yet covered, which would raise $9.3 billion (net) over five years. A second proposal would extend OASDI to new state and local employees, which would raise $7.5 billion (net) over five years. The budget effects shown here include the minor reductions in income tax revenues that result from the payroll tax increases.

Extending coverage to these employees would make their treatment more like that of employees in the private sector, who must contribute throughout their working years. Under current law, state and local employees who do not contribute may still be eligible for benefits, either through their spouses or because they work part of their lives in the private sector. Those who spend relatively few years in covered employment will have low Social Security earnings and contributions. Because benefits are based on earnings, and the current benefit formula redistributes benefits from high-earning workers to low-earning workers, state and local employees often receive a much higher ratio of benefits to lifetime contributions than other employees.

Many public employee benefit programs have more stringent vesting requirements for retirement, disability, and death benefits than does Social Security, especially for young workers. As a result, Social Security coverage for new state and local government workers would, after only a few years, improve the protection many of these workers and their families would have in the event of a worker's disability or death. Moreover, workers who change jobs and would lose eligibility for benefits under state and local plans would continue to be covered under Social Security, which does not depend on the worker's place of employment.

State and local governments would have to pay the employer share of these taxes if their employees were to become covered under OASDI, HI, or both. Representatives of some localities argue that this would be a difficult financial burden. State and local governments would also have to create a separate pension plan for workers newly covered by OASDI, so that their pension benefits would not duplicate Social Security retirement benefits. Maintaining separate pension plans would be administratively complex, and the funding for current state and local pension plans might be inadequate if new employees were no longer required to contribute to them. This problem would be most severe for governments that operate their pension plans on a pay-as-you-go basis.

APPENDIX

SUMMARY TABLE OF SPENDING AND TAXATION OPTIONS BY BUDGET FUNCTION

The table that follows lists deficit reduction options by budget function. When an option affects several functions, it is assigned to the function on which it has the largest impact. Some spending options affect all functions, and some taxation options cannot be classifed by function at all. Options of this kind are carried at the end of the table.

The title of each option is followed by a designation of its category in parentheses--for example, Slow Growth in the Strategic Defense Initiative (DEF-14) or Limit Mortgage Interest Deductions (REV-16). The designation permits locating the option in the table of contents at the beginning of this volume.

For each option, the table displays the estimated 1988-1992 savings of revenue gains that would result from enactment. Both budget authority and outlay savings are generally shown for the spending reduction options. Revenue increases are listed as additions to CBO baseline. The estimates do not include any secondary effects--that is, effects on spending or revenues that would occur if the performance of the economy as a whole were altered by enacting the options shown here.

Unless specified otherwise, the estimates assume that the spending reduction options in the table will take effect on October 1, 1987, and the taxation options on January 1, 1988. The separate options cannot be added to a grand total. Some are mutually exclusive; some overlap with others; and in some cases, there are interactions, so that if several options were enacted together, the combined savings would differ from the total of those estimated for each option separately.

SUMMARY TABLE PROJECTED SAVINGS AND REVENUE GAINS, BY BUDGET FUNCTION, FISCAL YEARS 1988-1992 (In millions of dollars)

Budget Function Options	1988	1989	1990	1991	1992	Cumulative Five-Year Savings
050 National Defense [a]						
Cancel Procurement of the F-15 (DEF-01)						
Budget Authority	1,790	1,800	1,930	1,810	1,670	9,000
Outlays	170	810	1,350	1,590	1,700	5,620
Cancel the C-17 Program (DEF-02)						
Budget Authority	1,940	2,080	2,710	3,020	3,870	13,620
Outlays	690	1,270	1,500	1,850	2,330	7,640
Cancel Antisatellite Missile (DEF-03)						
Budget Authority	420	750	500	500	400	2,570
Outlays	220	430	440	440	390	1,920
Cancel Trident Refit Program (DEF-04)						
Budget Authority	60	200	130	310	280	980
Outlays	10	50	110	190	250	610

NOTE: Dashes in this table indicate less than $2.5 million.

a. Unless otherwise specified, all figures are savings from the Administration's 1988 budget request.

SUMMARY TABLE (Continued)

Budget Function Options	1988	1989	1990	1991	1992	Cumulative Five-Year Savings
050 National Defense (Continued)						
Slow Trident SSBN Construction (DEF-05)						
Budget Authority	1,330	150	10	1,310	150	2,950
Outlays	70	200	300	320	450	1,340
Restructure the Army's Forward Area Air Defense Program (DEF-06)						
Budget Authority	300	490	510	310	220	1,830
Outlays	100	240	290	300	300	1,230
Defer New Program Starts Until 1990 (DEF-07)						
Budget Authority	8,350	12,220	5,980	7,750	4,320	38,620
Outlays	3,220	6,400	4,060	4,730	6,740	25,150
Reduce Purchases of MX Missiles (DEF-08)						
Budget Authority	940	1,580	970	1,260	1,150	5,900
Outlays	390	1,010	860	800	950	4,010
Cancel V-22 Aircraft Development (DEF-09)						
Budget Authority	470	640	2,140	2,800	2,550	8,600
Outlays	240	360	530	1,190	1,900	4,220

SUMMARY TABLE (Continued)

Budget Function Options	1988	1989	1990	1991	1992	Cumulative Five-Year Savings
050 National Defense (Continued)						
Restructure the Army Helicopter Programs (DEF-10)						
Budget Authority	800	310	320	260	-300	1,390
Outlays	270	580	550	500	120	2,020
Delay the Army's Deep-Attack Weapons (DEF-11)						
Budget Authority	230	320	360	160	-40	1,030
Outlays	90	160	210	180	160	800
Limit Funding for Supporting Procurement (DEF-12)						
Savings from Administration's Request						
Budget Authority	0	1,590	2,660	3,380	3,460	11,090
Outlays	0	430	1,180	2,070	2,730	6,410
Savings from CBO Baseline						
Budget Authority	1,880	1,350	750	80	-660	3,400
Outlays	500	910	1,050	770	170	3,400
Alter Research and Development Funding (DEF-13)						
Savings from Administration's Request						
Budget Authority	6,350	5,370	-790	-2,340	-1,370	7,220
Outlays	3,250	5,010	1,920	-990	-1,460	7,730
Savings from CBO Baseline						
Budget Authority	0	0	0	0	0	0
Outlays	0	0	0	0	0	0

SUMMARY TABLE (Continued)

Budget Function Options	1988	1989	1990	1991	1992	Cumulative Five-Year Savings
050 National Defense (Continued)						
Slow Growth in the Strategic Defense Initiative (DEF-14)						
Budget Authority	1,200	1,500	1,700	2,000	2,300	8,700
Outlays	540	1,170	1,460	1,740	2,020	6,930
Alter Funding for Military Construction (DEF-15)						
Savings from Administration's Request						
Budget Authority	1,550	1,670	2,070	2,140	2,710	10,140
Outlays	200	850	1,310	1,710	1,920	5,990
Savings from CBO Baseline						
Budget Authority	200	200	210	220	220	1,050
Outlays	30	110	160	190	190	680
Retire Some G-Model B-52 Strategic Bombers Early (DEF-16)						
Savings in Total Federal Budget						
Budget Authority	280	870	1,220	1,280	1,340	4,990
Outlays	130	480	820	1,000	1,220	3,650
Savings in Defense Budget						
Budget Authority	280	870	1,220	1,280	1,340	4,990
Outlays	150	550	910	1,100	1,230	3,940
Alter Operation and Maintenance Funding (DEF-17)						
Savings from Administration's Request						
Budget Authority	2,430	2,540	2,720	2,870	3,010	13,570
Outlays	1,840	2,430	2,640	2,790	2,930	12,630

SUMMARY TABLE (Continued)

Budget Function Options	1988	1989	1990	1991	1992	Cumulative Five-Year Savings
050 National Defense (Continued)						
Alter Operation and Maintenance Funding (DEF-17) (Continued)						
Savings from CBO Baseline						
Budget Authority	-830	-2,260	-5,890	-8,510	-10,810	-28,300
Outlays	-630	-1,880	-4,940	-7,710	-10,060	-25,220
Reduce Active-Duty End Strength to 1982 Level (DEF-18)						
Savings in Total Federal Budget						
Budget Authority	390	1,380	2,280	2,880	3,010	9,940
Outlays	260	930	1,580	2,020	2,160	6,950
Savings in Defense Budget						
Budget Authority	410	1,440	2,370	3,000	3,150	10,370
Outlays	360	1,400	2,340	2,960	3,140	10,220
Slow the Growth in Army Active Guard and Reserve Personel (DEF-19)						
Savings in Total Federal Budget						
Budget Authority	70	220	390	600	840	2,120
Outlays	50	150	270	420	600	1,490
Savings in Defense Budget						
Budget Authority	70	230	410	620	870	2,200
Outlays	70	220	400	610	850	2,150

SUMMARY TABLE (Continued)

Budget Function Options	1988	1989	1990	1991	1992	Cumulative Five-Year Savings
050 National Defense (Continued)						
Limit Military Pay Raise (DEF-20)						
Savings in Total Federal Budget						
Budget Authority	950	1,300	1,350	1,400	1,460	6,460
Outlays	610	910	970	1,010	1,060	4,550
Savings in Defense Budget						
Budget Authority	990	1,350	1,410	1,470	1,520	6,740
Outlays	920	1,330	1,410	1,460	1,520	6,640
Raise Cost-Sharing for Certain Outpatients (DEF-21)						
Budget Authority	110	120	120	130	130	610
Outlays	90	110	120	120	130	570
250 General Science, Space, and Technology						
Cancel the NASA International Space Station Program (NDD-21)						
Savings from CBO Baseline						
Budget Authority	430	450	480	500	530	2,390
Outlays	230	410	460	490	510	2,100
Savings from Administration's Request						
Budget Authority	770	1,840	2,000	2,200	2,140	8,950
Outlays	410	1,290	1,850	2,100	2,150	7,800

SUMMARY TABLE (Continued)

Budget Function Options	1988	1989	1990	1991	1992	Cumulative Five-Year Savings
250 General Science, Space, and Technology (Continued)						
Cancel Funding for a Space Shuttle to Replace the Challenger (NDD-22)						
Savings from CBO Baseline						
Budget Authority	0	0	0	0	0	0
Outlays	220	600	620	450	150	2,040
270 Energy						
Reduce Subsidies Provided by the Rural Electrification Administration (NDD-04)						
Savings from CBO Baseline						
Budget Authority	40	150	240	300	350	1,080
Outlays	40	150	240	300	350	1,080
Reduce Federal Funds for Research and Development in Energy Supply and Conservation (NDD-05)						
Savings from CBO Baseline						
Budget Authority	1,970	2,220	2,340	2,450	2,570	11,550
Outlays	940	1,730	2,150	2,330	2,470	9,620
Eliminate Energy Conservation Grants (NDD-06)						
Savings from CBO Baseline						
Budget Authority	210	220	230	230	240	1,130
Outlays	50	190	210	230	240	920

SUMMARY TABLE (Continued)

Budget Function Options	1988	1989	1990	1991	1992	Cumulative Five-Year Savings
270 Energy (Continued)						
Reduce Credit Subsidies to Federal Power Marketing Administrations (NDD-15)						
Savings from CBO Baseline						
Budget Authority	90	220	190	150	130	780
Outlays	360	590	520	460	410	2,340
Eliminate Purchases for the Strategic Petroleum Reserve (NDD-23)						
Savings from CBO Baseline						
Budget Authority	430	470	530	500	530	2,460
Outlays	330	460	510	520	520	2,340
Increase Energy Taxes (REV-04)						
Addition to CBO Baseline						
Impose Tax on Domestic and Imported Oil ($5 per barrel)	19,700	20,900	21,200	21,400	26,700	104,900
Impose Oil Import Fee ($5 per barrel)	8,100	7,200	7,200	7,700	8,400	38,500
Increase Motor Fuel Tax (12 cents per gallon)	10,600	11,100	10,900	10,800	11,000	54,400

SUMMARY TABLE (Continued)

Budget Function Options	1988	1989	1990	1991	1992	Cumulative Five-Year Savings
270 Energy (Continued)						
Increase Energy Taxes (REV-04) (Continued)						
Addition to CBO Baseline						
Impose Broad-Based Tax on Domestic Energy Consumption (5 percent of value)	13,400	15,000	16,100	17,000	18,300	79,800
Repeal Exemptions to the Gasoline Excise Tax (REV-06)						
Addition to CBO Baseline						
Repeal Gasohol Exemption and Credit	200	300	300	300	300	1,200
Repeal Bus Exemption	100	100	100	100	100	500
300 Natural Resources and Environment						
Change Revenue-Sharing Formula from a Gross to a Net Receipt Basis for the National Forest Timber Sales Program (NDD-07)						
Savings from CBO Baseline						
Budget Authority	240	200	200	200	200	1,040
Outlays	240	200	200	200	200	1,040

SUMMARY TABLE (Continued)

Budget Function Options	1988	1989	1990	1991	1992	Cumulative Five-Year Savings
300 Natural Resources and Environment (Continued)						
Eliminate Federal Support to States for Construction of Sewage Treatment Plants (NDD-14)						
Savings from CBO Baseline						
Budget Authority	520	760	1,200	1,740	2,080	6,310
Outlays	5	65	250	520	840	1,680
Transfer Control and Financing of Water Resources Programs to Users and Local Authorities (NDD-16)						
Savings from CBO Baseline						
Budget Authority	1,000	1,100	1,100	1,100	1,100	5,400
Outlays	700	1,000	1,100	1,100	1,100	5,000
350 Agriculture						
Reduce Federal Support for Agricultural Research and Extension Activities (NDD-01)						
Savings from CBO Baseline						
Budget Authority	300	310	330	340	350	1,630
Outlays	230	270	300	310	320	1,430
Phase Out Subsidies for Flood Insurance and Crop Insurance (NDD-10)						
Savings from CBO Baseline						
Crop Insurance						
Budget Authority	0	110	200	370	530	1,210
Outlays	0	170	310	570	830	1,880

SUMMARY TABLE (Continued)

Budget Function Options	1988	1989	1990	1991	1992	Cumulative Five-Year Savings
350 Agriculture (Continued)						
Phase Out Subsidies for Flood Insurance and Crop Insurance (NDD-10)						
Savings from CBO Baseline						
Flood Insurance						
Budget Authority	25	55	85	90	90	345
Outlays	25	60	90	100	110	385
Reduce Deficiency Payments by Lowering Target Prices (AGR-01)						
Savings from CBO Baseline						
Budget Authority	350	1,100	1,350	1,450	1,750	6,000
Outlays	350	1,100	1,350	1,450	1,750	6,000
Increase Requirements for Unpaid Acreage Reduction (AGR-02)						
Savings from CBO Baseline						
Budget Authority	900	1,650	1,500	1,400	1,400	6,850
Outlays	900	1,650	1,500	1,400	1,400	6,850
Target Income Support Payments Toward Specific Groups of Producers (AGR-03)						
Savings from CBO Baseline						
Budget Authority	600	1,450	1,300	1,200	1,200	5,750
Outlays	600	1,450	1,300	1,200	1,200	5,750

SUMMARY TABLE (Continued)

Budget Function Options	1988	1989	1990	1991	1992	Cumulative Five-Year Savings
350 Agriculture (Continued)						
Limit the Uses of Generic Commodity Certificates (AGR-04)						
Savings from CBO Baseline						
Budget Authority	410	400	260	230	100	1,400
Outlays	410	400	260	230	100	1,400
Raise Domestic Prices of Supported Agricultural Commodities (AGR-05)						
Savings from CBO Baseline						
Budget Authority	120	-1,800	900	980	1,730	1,930
Outlays	120	-1,800	900	980	1,730	1,930
Reduce Effects of Income Support Payments on Production Decisions (AGR-06)						
Savings from CBO Baseline						
Budget Authority	50	950	-750	250	1,400	1,900
Outlays	50	950	-750	250	1,400	1,900
370 Commerce and Housing						
Reduce New Lending or Increase Homeowners' Payments Under Rural Housing Loan Program (NDD-02)						
Savings from CBO Baseline						
Reduce New Lending						
Budget Authority	520	640	580	550	540	2,820
Outlays	500	620	610	610	600	2,940

SUMMARY TABLE (Continued)

Budget Function Options	1988	1989	1990	1991	1992	Cumulative Five-Year Savings
370 Commerce and Housing (Continued)						
Reduce New Lending or Increase Homeowners' Payments Under Rural Housing Loan Program (NDD-02) (Continued)						
Increase Borrowers' Payments						
Budget Authority	-15	-30	--	40	80	75
Outlays	35	75	120	160	200	590
End Direct and Indirect Postal Subsidies (NDD-13)						
Savings from CBO Baseline						
End Direct Subsidies						
Budget Authority	160	660	690	720	750	2,980
Outlays	160	660	690	720	750	2,980
End Indirect Subsidies						
Budget Authority	20	35	370	360	-680	105
Outlays	430	1,500	1,700	1,550	420	5,600
Total						
Budget Authority	180	695	1,060	1,080	70	3,085
Outlays	590	2,160	2,390	2,270	1,170	8,580
Tax Credit Unions Like Other Thrift Institutions (REV-08)						
Addition to CBO Baseline	200	400	400	500	500	2,000

SUMMARY TABLE (Continued)

Budget Function Options	1988	1989	1990	1991	1992	Cumulative Five-Year Savings
370 Commerce and Housing (Continued)						
Tax Capital Gains at Death (REV-11)						
Addition to CBO Baseline	b/	4,900	5,300	5,600	6,000	21,900
Tax 30 Percent of Capital Gains from Home Sales (REV-12)						
Addition to CBO Baseline	400	2,000	2,200	2,300	2,500	9,400
Further Restrict Deductions for Business Entertainment and Meals (REV-15)						
Addition to CBO Baseline						
Disallow Deductions for Half of Business Entertainment and Meal Expenses	1,300	2,400	2,800	3,200	3,600	13,400
Limit Mortgage Interest Deductions (REV-16)						
Addition to CBO Baseline						
Limit Deductions to $12,000 per Return (single) or $20,000 (joint)	400	1,000	1,100	1,200	1,400	5,100
Limit the Value of Deductions to 15 Percent	1,400	9,500	10,600	11,700	12,700	46,000

b. Less than $50 million.

SUMMARY TABLE (Continued)

Budget Function Options	1988	1989	1990	1991	1992	Cumulative Five-Year Savings
370 Commerce and Housing (Continued)						
Limit Mortgage Interest Deductions (REV-16) (Continued)						
Addition to CBO Baseline						
Eliminate Deductions for Second Homes	100	200	300	300	400	1,300
400 Transportation						
Transfer Control and Financing of Transportation Programs to Users and Local Authorities (NDD-16)						
Savings from CBO Baseline						
Budget Authority	4,990	5,175	5,225	5,380	5,485	26,255
Outlays	3,675	4,580	4,995	5,160	5,255	23,665
450 Community and Regional Development						
Eliminate or Restrict Eligibility for Community Development Block Grants (NDD-19)						
Savings from CBO Baseline						
Terminate CDBG						
Budget Authority	3,100	3,250	3,350	3,500	3,650	16,850
Outlays	60	1,250	2,900	3,300	3,400	10,900

SUMMARY TABLE (Continued)

Budget Function Options	1988	1989	1990	1991	1992	Cumulative Five-Year Savings
450 Community and Regional Development (Continued)						
Eliminate or Restrict Eligibility for Community Development Block Grants (NDD-19) (Continued)						
Restrict Eligibility and Reduce Funding						
Budget Authority	430	450	460	480	500	2,320
Outlays	10	170	400	450	470	1,500
End Funding of the Economic Development Administration and Urban Development Action Grants (NDD-20)						
Savings from CBO Baseline						
Terminate EDA						
Budget Authority	230	240	250	260	270	1,240
Outlays	25	100	170	220	240	760
Terminate UDAG						
Budget Authority	230	240	250	260	270	1,260
Outlays	10	60	120	180	250	620
Reduce Tax Credits for Rehabilitation of Older Buildings (REV-07)						
Addition to CBO Baseline						
Limit Rehabilitation Tax Credits to Historic Renovations	b/	100	200	300	300	900
Repeal the Credits	300	700	1,400	1,800	1,900	6,000

b. Less than $50 million.

SUMMARY TABLE (Continued)

Budget Function Options	1988	1989	1990	1991	1992	Cumulative Five-Year Savings
450 Community and Regional Development (Continued)						
Eliminate Funding for Untargeted Elementary and Secondary Education Programs (NDD-17)						
Savings from CBO Baseline						
Eliminate Chapter 2 Block Grant						
Budget Authority	560	590	620	660	690	3,110
Outlays	45	430	580	620	650	2,320
Eliminate Untargeted Portion of Vocational Education						
Budget Authority	430	450	480	500	530	2,390
Outlays	10	340	450	470	500	1,770
Eliminate Mathematics and Science Education						
Budget Authority	85	90	95	100	100	470
Outlays	5	55	85	90	95	340
500 Education, Training, Employment, and Social Services						
Reduce Campus-Based Student Aid (NDD-18)						
Savings from CBO Baseline						
Budget Authority	250	270	280	300	310	1,400
Outlays	25	240	270	250	300	1,080

SUMMARY TABLE (Continued)

Budget Function Options	1988	1989	1990	1991	1992	Cumulative Five-Year Savings
500 Education, Training, Employment, and Social Services (Continued)						
Reduce and Retarget Aid for Dependent Care (ENT-21)						
Savings from CBO Baseline						
Gross Revenue Gain	270	1,800	2,000	2,150	2,350	8,550
Outlays	135	900	1,000	1,075	1,175	4,275
Net Savings	135	900	1,000	1,075	1,175	4,275
550 Health						
Reduce Funding for Research Supported by the National Institutes of Health (NDD-03)						
Savings from CBO Baseline						
Budget Authority	320	330	350	370	390	1,750
Outlays	140	310	340	360	370	1,520
Modify the Federal Employees Health Benefits Program (FWF-03)						
Savings from CBO Baseline						
Outlays	150	260	350	520	660	1,940
Recover the Operating Costs of Selected Regulatory Agencies (NDD-12)						
Addition to CBO Baseline						
USDA	145	300	465	470	480	1,860
FDA	100	205	310	320	325	1,260
FCC	10	20	35	35	35	135
CFTC	10	20	30	30	35	125

SUMMARY TABLE (Continued)

Budget Function Options	1988	1989	1990	1991	1992	Cumulative Five-Year Savings
550 Health (Continued)						
Limit Federal Payments for Long-Term Care (ENT-12)						
Savings from CBO Baseline						
Reduce Federal Medicaid Matching Rate						
Budget Authority	790	870	950	1,040	1,130	4,780
Outlays	790	870	950	1,040	1,130	4,780
Limit Federal Medicaid Increases to the Medical CPI Rate						
Budget Authority	860	930	1,020	1,100	1,190	5,100
Outlays	860	930	1,020	1,100	1,190	5,100
Establish a Comprehensive Block Grant						
Budget Authority	1,350	2,900	4,400	6,000	7,650	22,350
Outlays	1,350	2,900	4,400	6,000	7,650	22,350
Tax Employer-Paid Health Insurance (ENT-13)						
Addition to CBO Baseline						
Tax Some Employer-Paid Health Insurance						
Income Tax	2,000	3,700	4,500	5,500	6,500	22,200
Payroll Tax	1,200	2,000	2,400	3,000	3,500	12,100
Tax Employer-Paid Health Insurance But Allow a Credit for Some Employer and Employee Contributions						
Income Tax	9,200	3,200	3,900	5,000	6,300	27,600
Payroll Tax	9,500	15,000	17,000	18,800	20,700	81,000

SUMMARY TABLE (Continued)

Budget Function Options	1988	1989	1990	1991	1992	Cumulative Five-Year Savings
570 Medicare						
Recalculate Medicare's Prospective Payment Rates Using More Recent Cost Data (ENT-01)						
Savings from CBO Baseline						
Reduce the Payment Rates by 10.1 Percent						
Outlays	4,400	4,850	5,400	5,950	6,600	27,200
Reduce the Payment Rates by 7.1 Percent						
Outlays	3,050	3,350	3,750	4,150	4,550	18,900
Reduce Medicare's Payments for the Indirect Costs of Medical Education (ENT-02)						
Savings from CBO Baseline						
Outlays	370	450	500	550	600	2,470
Reduce Reimbursements for Capital Expenditures Under Medicare (ENT-03)						
Savings from CBO Baseline						
Move Immediately to a Prospective Reimbursement System						
Outlays	120	180	220	250	310	1,080
Move Immediately to a Prospective Reimbursement System and Redefine Capital Expenses						
Outlays	290	330	340	390	450	1,800

SUMMARY TABLE (Continued)

Budget Function Options	1988	1989	1990	1991	1992	Cumulative Five-Year Savings
570 Medicare (Continued)						
Reduce Reimbursements for Capital Expenditures Under Medicare (ENT-03) (Continued)						
Savings from CBO Baseline						
Move Slowly to a Prospective Reimbursement System and Redefine Capital Expenses						
Outlays	10	45	120	220	360	700
Reduce Total Medicare Direct Medical Education Payments (ENT-04)						
Savings from CBO Baseline						
Outlays	150	160	170	170	180	830
Adopt a Fee Schedule for Reimbursing Physicians Under Medicare (ENT-05)						
Savings from CBO Baseline						
Fee Schedule with Rates Updated Annually by the MEI						
Outlays	90	340	500	660	820	2,410
Fee Schedule with Spending Cap Set by the MEI						
Outlays	560	2,140	3,680	5,410	7,380	19,170
Fee Schedule with Spending Cap Set by Growth in GNP						
Outlays	200	770	1,250	1,880	2,670	6,770

SUMMARY TABLE (Continued)

Budget Function Options	1988	1989	1990	1991	1992	Cumulative Five-Year Savings
570 Medicare (Continued)						
Include Hospital-Based Physicians' Services in Hospitals' Prospective Payments (ENT-06)						
Savings from CBO Baseline						
Outlays	70	170	240	310	400	1,190
Increase Medicare's Premium for Physicians' Services (ENT-07)						
Savings from CBO Baseline						
Outlays	1,180	2,210	3,080	4,060	5,180	15,710
Use the Tax System to Impose a Supplementary Income-Related Premium for Physicians' Services (ENT-08)						
Addition to CBO Baseline	600	2,000	2,200	2,400	2,600	9,800
Tax a Portion of Medicare Benefits (ENT-09)						
Addition to CBO Baseline						
With Income Threshold	700	2,500	3,000	3,600	4,200	14,000
Without Income Threshold	1,400	5,000	5,600	6,400	7,200	25,600
Increase Medicare's Deductible for Physician Services (ENT-10)						
Savings from CBO Baseline						
Outlays	1,000	1,670	1,930	2,120	2,320	9,040

SUMMARY TABLE (Continued)

Budget Function Options	1988	1989	1990	1991	1992	Cumulative Five-Year Savings
570 Medicare (Continued)						
Cap Each Enrollee's Copayment Liability Under Medicare and Impose a Tax on "Medigap" Policies (ENT-11)						
Savings from CBO Baseline						
Outlays	860	2,700	3,760	4,140	4,350	15,810
600 Income Security						
Shift Housing Assistance from New Construction to Vouchers (NDD-09)						
Savings from CBO Baseline						
Budget Authority	1,350	1,350	1,400	1,450	1,500	7,050
Lending Authority	410	430	450	470	490	2,240
Outlays	--	20	130	260	310	720
Cap Cost-of-Living Adjustments for Federal Retirees Under Age 62 (FWF-02)						
Savings from CBO Baseline						
Military Retirement	80	200	330	480	640	1,730
Civilian Retirement	30	60	90	130	170	480

SUMMARY TABLE (Continued)

Budget Function Options	1988	1989	1990	1991	1992	Cumulative Five-Year Savings
600 Income Security (Continued)						
Decrease Limits on Contributions to Qualified Pension and Profit-Sharing Plans (REV-13)						
Addition to CBO Baseline						
Decrease Limits to $45,000 and $15,000	900	2,500	2,800	3,200	3,600	12,900
Decrease Limits to $67,500 and $22,500	200	600	600	700	800	2,900
Repeal Salary Reduction Plans	2,800	5,700	6,200	7,100	8,100	29,800
Decrease the Limit for Deferrals in Salary Reduction Plans to $5,000	100	300	300	400	400	1,400
Impose a 5 Percent Tax on the Investment Income of Qualified Retirement Plans and IRAs (REV-14)						
Addition to CBO Baseline	2,100	3,600	3,800	4,000	4,200	17,600
Tax Nonretirement Fringe Benefits (REV-19)						
Addition to CBO Baseline						
Tax Some Health Insurance Premiums						
Income tax	2,000	3,700	4,500	5,500	6,500	22,200
Payroll tax	1,200	2,000	2,400	3,000	3,500	12,100

SUMMARY TABLE (Continued)

Budget Function Options	1988	1989	1990	1991	1992	Cumulative Five-Year Savings
600 Income Security (Continued)						
Tax Nonretirement Fringe Benefits (REV-19) (Continued)						
Addition to CBO Baseline						
Tax Life Insurance Premiums						
Income Tax	1,200	1,800	1,900	2,000	2,100	9,000
Payroll Tax	600	900	1,100	1,000	1,100	4,700
Require a Two-Week Waiting Period for Unemployment Insurance Benefits (ENT-18)						
Savings from CBO Baseline						
Budget Authority	--	--	--	--	--	--
Outlays	--	1,200	1,300	1,450	1,500	5,450
Index the Unemployment Insurance Taxable Wage Base (ENT-19)						
Addition to CBO Baseline	--	200	600	700	600	2,100
Maintain the Current Federal Unemployment Insurance Tax Rate (ENT-20)						
Addition to CBO Baseline	700	800	800	500	300	3,100

SUMMARY TABLE (Continued)

Budget Function Options	1988	1989	1990	1991	1992	Cumulative Five-Year Savings
650 Social Security						
Increase Taxation of Non-Means-Tested Entitlement Benefits (REV-18)						
Addition to CBO Baseline						
Increase Taxation of Social Security and Railroad Retirement Tier I						
Tax 50 percent of benefits	2,100	7,100	7,500	7,800	8,200	32,700
Tax 85 percent of benefits	4,600	15,600	16,800	17,900	19,100	74,000
Tax Workers' Compensation and Black Lung Benefits	1,000	3,200	3,500	3,800	4,100	15,600
Broaden the Social Security Tax Base (REV-20)						
Addition to CBO Baseline						
Extend HI Coverage to State and Local Government Workers Not Now Covered	1,300	1,900	1,900	2,000	2,100	9,300
Extend OASDI Coverage to New State and Local Government Workers	200	900	1,500	2,100	2,800	7,500

SUMMARY TABLE (Continued)

Budget Function Options	1988	1989	1990	1991	1992	Cumulative Five-Year Savings
650 Social Security (Continued)						
Restrict Cost-of-Living Adjustments in Non-Means-Tested Benefit Programs (ENT-14)						
Savings from CBO Baseline						
Eliminate COLAs for One Year						
Social Security/ Railroad Retirement	6,550	9,000	9,050	9,050	8,850	42,500
Other Non-Means-Tested Programs	1,700	2,300	2,400	2,450	2,550	11,450
Offsets in Means-Tested Programs and Medicare Premiums	-1,150	-1,900	-2,050	-2,200	-2,300	-9,600
Limit COLAs to Two-Thirds of CPI Increase for Five Years						
Social Security/ Railroad Retirement	2,250	5,400	9,000	12,600	16,250	45,450
Other Non-Means-Tested Programs	580	1,400	2,300	3,250	4,300	11,850
Offsets in Means-Tested Programs and Medicare Premiums	-70	-240	-430	-670	-910	-2,300

SUMMARY TABLE (Continued)

Budget Function Options	1988	1989	1990	1991	1992	Cumulative Five-Year Savings
650 Social Security (Continued)						
Restrict Cost-of-Living Adjustments in Non-Means-Tested Benefit Programs (ENT-14) (Continued)						
Limit COLAs to CPI Increase Minus Two Percentage Points for Five Years						
Social Security/ Railroad Retirement	3,200	7,750	12,500	17,500	22,650	63,550
Other Non-Means-Tested Programs	830	2,000	3,200	4,550	5,950	16,550
Offsets in Means-Tested Programs and Medicare Premiums	-100	-340	-610	-940	-1,250	-3,250
Pay Full COLA on Benefits Below a Certain Level and 50 Percent of COLA on Amounts Exceeding That Level						
Social Security/ Railroad Retirement	710	1,750	2,900	4,050	5,250	14,650
Reduce the Replacement Rate Within Each Bracket of the Social Security Benefit Formula (ENT-15)						
Savings from CBO Baseline						
Outlays	80	280	530	850	1,250	3,000

SUMMARY TABLE (Continued)

Budget Function Options	1988	1989	1990	1991	1992	Cumulative Five-Year Savings
650 Social Security (Continued)						
Eliminate Social Security Benefits for Children of Retirees Aged 62-64 (ENT-16)						
Savings from CBO Baseline						
Outlays	40	180	360	590	650	1,820
700 Veterans' Benefits and Services						
Convert Underused Acute-Care Beds in VA Hospitals (NDD-11)						
Savings from CBO Baseline						
Budget Authority	10	120	180	240	310	860
Outlays	35	110	170	230	290	840
Eliminate Certain Veterans' Compensation Payments for Those with Low-Rated Disabilities or End Allowances for Dependents (ENT-17)						
Savings from CBO Baseline						
Eliminate Compensation for Low-Rated Disabilities						
Budget Authority	1,300	1,350	1,450	1,450	1,550	7,100
Outlays	1,200	1,350	1,400	1,400	1,550	7,000
End Certain Dependents' Allowances						
Budget Authority	210	220	230	240	240	1,130
Outlays	190	220	230	230	240	1,110

SUMMARY TABLE (Continued)

Budget Function Options	1988	1989	1990	1991	1992	Cumulative Five-Year Savings
750 Administration of Justice						
End Funding for the Legal Services Corporation (NDD-08)						
Savings from CBO Baseline						
Budget Authority	320	340	360	380	400	1,800
Outlays	320	340	360	380	400	1,800
850 General Purpose Fiscal Assistance						
Eliminate Private-Purpose Tax-Exempt Bonds (REV-10)						
Addition to CBO Baseline						
Eliminate All Private-Purpose Tax-Exempt Bonds	300	900	1,600	2,100	2,500	7,500
Raise Cap and Extend Volume Limits to New Issues of All Private-Purpose Bonds	100	200	400	500	900	2,100
Eliminate Deductibility of State and Local Taxes (REV-17)						
Addition to CBO Baseline						
Eliminate Deductibility of State and Local Taxes	3,400	22,900	24,600	26,500	28,500	105,900

SUMMARY TABLE (Continued)

Budget Function Options	1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Options Not Assignable to a Function (Continued)						
Raise Marginal Tax Rates for Individuals and Corporations (REV-01) (Continued)						
Addition to CBO Baseline						
Individuals						
Add a 33 Percent Bracket	2,800	6,500	8,800	11,400	14,100	43,700
Corporations						
Retain Transitional 1987 Tax Rate for an Additional Year	8,200	5,500	--	--	--	13,700
Raise Marginal Tax Rate to 35 Percent	1,500	2,600	2,900	3,100	3,300	13,400
Amend or Repeal Indexing of Income Tax Schedules (REV-02)						
Addition to CBO Baseline						
Repeal Indexing	--	3,600	11,600	23,100	36,900	75,300
Eliminate the Indexing Adjustment Scheduled for 1989	--	3,600	6,300	7,000	7,700	24,600
Impose a Value-Added Tax (REV-03)						
Addition to CBO Baseline						
5 Percent Tax, Comprehensive Base	--	73,800	107,500	110,900	114,300	406,500

SUMMARY TABLE (Continued)

Budget Function Options	1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Options Not Assignable to a Function (Continued)						
Impose a Value-Added Tax (REV-03) (Continued)						
Addition to CBO Baseline						
5 Percent Tax, Narrower Base, Exemptions for Food, Housing and Medical Care	--	42,600	62,100	64,000	65,800	234,600
5 Percent Tax, Narrower Base, No Exemptions for Food, Drugs, and Medical Care; Low-Income Relief Under Means-Tested Programs	--	56,000	81,500	83,300	84,700	305,300
Increase Excise Taxes (REV-05)						
Addition to CBO Baseline						
Extend the Telephone Tax	1,300	2,300	2,500	2,700	3,000	11,700
Raise the Cigarette Tax to 32 Cents per Pack	2,900	3,100	3,100	3,000	2,900	15,100
Increase Taxes on Distilled Spirits	400	600	600	600	600	2,700
Raise Taxes on Beer and Wine to Rate on Distilled Spirits	4,200	5,700	5,800	5,900	6,000	27,600

SUMMARY TABLE (Continued)

Budget Function Options	1988	1989	1990	1991	1992	Cumulative Five-Year Savings
Options Not Assignable to a Function (Continued)						
Increase Excise Taxes (REV-05) (Continued)						
Addition to CBO Baseline						
Index Current Cigarette and Alcohol Tax Rates for Inflation	400	700	1,100	1,200	1,400	4,800
Repeal Tax Preferences for Extractive Industries (REV-09)						
Addition to CBO Baseline						
Repeal Percentage Depletion	500	900	900	1,000	1,000	4,200
Repeal Expensing of Intangible Drilling, Exploration, and Development Costs	1,100	1,700	1,400	1,200	1,100	6,500
Bring Oil and Gas Losses Within the Passive Loss Limitation	100	300	300	400	500	1,600